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S. 437, A BILL TO AMEND THE SBIC ACT TO PERMIT PREPAYMENT OF SECTION 503 LOANS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

S. 437, A BILL TO AMEND THE SBIC ACT TO PERMIT PREPAYMENT OF SECTION 503 LOANS

JUNE 18, 1987

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CONTENTS

	Page
Statement of Senators:	
Bumpers, Hon. Dale, a U.S. Senator from the State of Arkansas	1
Dixon, Hon. Alan J., a U.S. Senator from the State of Illinois	5
D'Amato, Hon. Alfonse M., a U.S. Senator from the State of New York	10
Metzenbaum, Hon. Howard M., a U.S. Senator from the State of Ohio	37
Pressler, Hon. Larry, a U.S. Senator from the State of South Dakota	50
Weicker, Hon. Lowell, Jr., a U.S. Senator from the State of Connecticut	53
Statement of:	
Bartlett, Bruce L, president, Roberge Sheet Metal, Inc., Seattle, WA	54
Compton, Don T., president, Whitewater Industries, Harrison, OH	69
Holloway, Edwin T., Associate Administrator for Finance and Investment, U.S. Small Business Administration	14
Main, David K., executive director, Hamilton County Development Co., Cincinnati, OH, and president, National Association of Development Companies	71
Sethness, Hon. Charles O., Assistant Secretary for Domestic Finance, U.S. Department of the Treasury	12

APPENDIX

Letter dated July 6, 1987, from Richard Frankel, Orange, CT	112

HEARING DATE

June 18, 1987:	
Morning session	1

S. 437, A BILL TO AMEND THE SBIC ACT TO PERMIT PREPAYMENT OF SECTION 503 LOANS

THURSDAY, JUNE 18, 1987

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to notice, at 9:42 a.m. in Room SR-428A, Russell Senate Office Building, Hon. Dale Bumpers (Chairman of the Committee) presiding.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

The CHAIRMAN. The Committee will come to order.

I am going to insert my opening statement into the record and I will allow other members of the Committee to do likewise as they appear and as they choose.

[The prepared statements of Senators Bumpers, Dixon, and D'Amato follow:]

STATEMENT OF SENATOR DALE BUMPERS

CHAIRMAN

COMMITTEE ON SMALL BUSINESS

JUNE 18, 1987

I WOULD LIKE TO THANK SENATOR METZENBAUM FOR PAYING US ANOTHER VISIT THIS MORNING TO ADDRESS LEGISLATION WHICH HE HAS INTRODUCED, AND WHICH WAS REFERRED TO THIS COMMITTEE, THAT IS OF CRUCIAL IMPORTANCE TO ONE SEGMENT OF OUR NATION'S SMALL BUSINESSES. S. 437 ADDRESSES A SERIOUS PROBLEM WITH THE SECTION 503 ECONOMIC DEVELOPMENT LOAN PROGRAM, ONE OF THE MOST SUCCESSFUL OFFERED BY THE SMALL BUSINESS ADMINISTRATION. THE PROGRAM WAS ORIGINALLY ESTABLISHED TO PROVIDE LONG-TERM FINANCING THROUGH A TRUE PUBLIC-PRIVATE PARTNERSHIP FOR SMALL BUSINESSES SO THAT THEY WOULD HAVE THE ABILITY TO EXPAND AND CREATE JOBS. RECENT REPORTS FROM ACROSS THE COUNTRY INDICATE, HOWEVER, THAT FOR SOME LOAN RECIPIENTS THE 503 PROGRAM HAS BEGUN TO STIFLE THE GROWTH OF SMALL BUSINESSES BECAUSE OF ONEROUS PREPAYMENT PENALTIES CONTAINED IN DEVELOPMENT COMPANY DEBENTURES WHICH WERE PURCHASED BY THE FEDERAL FINANCING BANK UNDER SECTION 503. THE TERMS OF

THESE PREPAYMENT PENALTIES WERE, I BELIEVE, DICTATED BY THE TREASURY DEPARTMENT, AND I LOOK FORWARD TO HEARING THE TREASURY'S JUSTIFICATION FOR THIS POLICY.

OVER THE LAST SIX YEARS, THE 503 LOAN PROGRAM HAS BEEN A MODEL OF PUBLIC-PRIVATE SECTOR COOPERATION. MORE THAN 5,000 SMALL BUSINESSES HAVE BEEN ASSISTED BY THE PROGRAM AND HAVE RECEIVED APPROXIMATELY 60 PERCENT OF THEIR FUNDS FROM PRIVATE LENDERS. APPROXIMATELY 100,000 JOBS HAVE BEEN CREATED DUE TO THE PROGRAM. MANY MEMBERS OF THE SMALL BUSINESS COMMUNITY CAN ATTRIBUTE THEIR RAPID GROWTH TO THE 503 PROGRAM AND THE SOURCE OF INVESTMENT CAPITAL IT PROVIDES.

S. 437 WAIVES THE PREPAYMENT PENALTIES THAT BORROWERS WOULD NOW BE REQUIRED TO PAY TO THE TREASURY IF THEY WISH TO REFINANCE THROUGH COMMERCIAL LENDERS OR EXISTING SBA LOAN PROGRAMS. MANY SMALL BUSINESSES THAT JOINED THE PROGRAM WHEN INTEREST RATES WERE IN THE STRATOSPHERE CAN NOW FIND MUCH LOWER RATES FROM COMMERCIAL LENDERS. WHILE MANY WOULD LIKE TO PREPAY IN ORDER TO REFINANCE THESE OBLIGATIONS, THE SEVERE PENALTIES, WHICH ARE OFTEN 30 TO 40 PERCENT OF THEIR OUTSTANDING BALANCE, STOP THEM IN THEIR TRACKS.

HOWEVER, AS ONEROUS AS THESE PENALTIES ARE, WE MUST ALSO CONSIDER THE IMPACT THAT THIS LEGISLATION COULD HAVE UPON THE FEDERAL BUDGET DEFICIT. THE CONGRESSIONAL BUDGET OFFICE HAS BEEN REQUESTED TC PREPARE A COST ESTIMATE ON THIS BILL, BUT THUS FAR NONE HAS BEEN FORTHCOMING.

THE WITNESSES THAT ARE OFFERING THEIR VALUABLE TIME TODAY WILL HELP US TO RESOLVE MANY OF THE ISSUES PRESENTED BY THIS LEGISLATION, AND I APPRECIATE ALL OF THEM, AND PARTICULARLY OUR SMALL BUSINESS WITNESSES, FOR TAKING THE TIME AND EXPENSE TO TRAVEL TO WASHINGTON TO BE WITH US TODAY.

NOW I WILL TURN TO OUR DISTINGUISHED RANKING REPUBLICAN MEMBER, SENATOR WEICKER, FOR HIS COMMENTS.

JUNE 18, 1987

STATEMENT BY SENATOR ALAN J. DIXON

COMMITTEE ON SMALL BUSINESS

AMENDMENT OF SMALL BUSINESS INVESTMENT ACT

OF 1958

TO PERMIT PREPAYMENT OF LOANS

MADE TO STATE AND LOCAL DEVELOPMENT COMPANIES

THANK YOU, MR. CHAIRMAN. AS YOU KNOW, THE SMALL BUSINESS ADMINISTRATION 503 LOAN PROGRAM WAS DESIGNED TO SPARK SMALL BUSINESS EXPANSION BY PROVIDING LONG TERM FINANCING FOR ACQUISITION OF LAND, PLANT AND EQUIPMENT. THIS ALSO HELPS THE COMMUNITY BY CREATING JOBS.

BY ALL ACCOUNTS, THE PROGRAM HAS BEEN SUCCESSFUL. APPROXIMATELY 600 DEVELOPMENT COMPANIES HAVE BEEN CERTIFIED AND 6700 LOANS TOTALING MORE THAN $1.3 BILLION HAVE BEEN APPROVED BY THE SMALL BUSINESS ADMINISTRATION.

BUT THESE SMALL BUSINESS BORROWERS ARE BEING UNFAIRLY PENALIZED. THEY MUST PAY A PENALTY TO PREPAY THEIR LOANS. YOU AND I AREN'T PENALIZED WHEN WE PREPAY OUR CAR OR HOME LOANS. WE HAD THE OPPORTUNITY TO TAKE ADVANTAGE OF THE LOWER INTEREST RATES TO REFINANCE OUR LOANS LAST YEAR. THE SMALL BUSINESS BORROWER CAN ONLY DO THIS UNDER A STIFF PENALTY. AS WITNESSES WILL DEMONSTRATE, THE PENALTIES OFTEN RUN 30-40%. IT IS EQUAL TO THE AMOUNT OF INTEREST THAT THE BORROWER WOULD PAY SHOULD THE LOAN BE PAID TO FULL TERM. GIVEN THOSE RESTRICTIONS, THERE IS LITTLE BENEFIT TO PREPAYMENT.

THE 503 LOAN PROGRAM HAS BEEN A VALUABLE TOOL FOR SMALL BUSINESSES. I WOULD HATE TO SEE AN ISSUE SUCH AS PREPAYMENT OF LOANS SLOW THE CREATION OF JOBS AND EXPANSION OF BUSINESS THAT THIS LOAN PROGRAM HAS SPURRED.

AS COSPONSOR OF THIS LEGISLATION, I LOOK TO MR. SETHNESS FROM THE DEPARTMENT OF THE TREASURY FOR THE RATIONALE BEHIND THE CONTINUATION OF THE PREPAYMENT TERMS IMPOSED BY THE FEDERAL FINANCING BANK ON 503 LOANS.

AGAIN, MR. CHAIRMAN, I WOULD LIKE TO THANK YOU FOR HOLDING THESE HEARINGS AND I WOULD LIKE TO EXTEND A SPECIAL THANKS TO SENATOR METZENBAUM FOR INTRODUCING THIS BILL AND FOR HIS CONTINUED VIGILANCE ON BEHALF OF THE SMALL BUSINESS COMMUNITY.

STATEMENT BY SENATOR ALFONSE M. D'AMATO

BEFORE THE SENATE SMALL BUSINESS COMMITTEE

JUNE 18, 1987

MR. CHAIRMAN, I WOULD LIKE TO WELCOME TO THE SMALL BUSINESS COMMITTEE THIS MORNING OUR DISTINGUISHED PANEL OF WITNESSES WHO WILL SHARE THEIR CONCERNS OVER THE SMALL BUSINESS ADMINISTRATION'S 503 LOAN PROGRAM.

AS WE ARE ALL AWARE, THE SBA 503 LOAN PROGRAM WAS ORIGINALLY ESTABLISHED TO PROVIDE LONG TERM FINANCING FOR SMALL BUSINESSES. THESE LOANS ARE USED FOR THE ACQUISITION OF LAND, PLANT AND EQUIPMENT IN ORDER TO INDUCE BUSINESS EXPANSION AND THE CREATION OF JOBS. SINCE ITS INCEPTION IN 1980, THE 503 PROGRAM HAS BOASTED A FLOURISHING TRACK RECORD. NEARLY 5,000 SMALL BUSINESSES HAVE BEEN HELPED BY THE PROGRAM AND MORE THAN $800 MILLION IN LOANS HAS BEEN MADE AVAILABLE TO THESE BUSINESSES. AN EXTRAORDINARY ASPECT OF THE PROGRAM IS THAT IT HAS ATTRACTED A LARGE AMOUNT OF CAPITAL FROM PRIVATE LENDERS.

UNFORTUNATELY, AS THINGS STAND NOW, A PROGRAM DEVELOPED WITH THE INTENT OF AIDING SMALL BUSINESSES HAS BEGUN TO FOSTER A SITUATION WHICH, IN EFFECT, HAS STIFLED THE GROWTH OF SOME OF THESE BUSINESSES. THE LACK OF AFFORDABLE FINANCING PREVENTS SMALL BUSINESSES FROM EXPANDING, AND CURBS THEIR ABILITY TO CREATE NEW JOBS. FACED WITH EXHORBITANTLY HIGH INTEREST RATES WHEN CERTAIN 503 LOANS WERE CLOSED, SMALL BUSINESSES ARE FINDING IT

INCREASINGLY DIFFICULT TO REPAY THE PREPAYMENT PREMIUM ACCORDING TO THEIR DEBT SCHEDULES. THE FEDERAL FINANCING BANK, WHICH HOLDS THE DEBENTURES ON 503 LOANS, HAS PLACED HIGH-INTEREST RATES AND A PREPAYMENT FORMULA ON 503 BORROWERS WHICH CAN NOT BE MET BY MANY SMALL BUSINESSES WITHOUT DRAMATICALLY CHOKING THEIR GROWTH POTENTIAL.

I LOOK FORWARD TO THE TESTIMONY OF OUR WITNESSES THIS MORNING AND HOPE THAT THEY WILL SHARE THEIR FIRST HAND EXPERIENCES WITH THE 503 LOAN PROGRAM AND OFFER SOME VIABLE SUGGESTIONS TO ASSIST US IN SHAPING APPROPRIATE LEGISLATION.

THANK YOU, MR. CHAIRMAN.

The CHAIRMAN. Senator Metzenbaum is to be our lead-off witness. He is not here yet, so we will take our first panel: The Honorable Charles O. Sethness, Assistant Secretary for Domestic Finance, U.S Department of the Treasury; and Mr. Edwin T. Holloway, Associate Administrator for Finance and Investment at the SBA.

Gentlemen, if you will take your respective seats there. I will be anxious to hear from you.

Since you are number one, Secretary Sethness, why do you not lead off.

STATEMENT OF HON. CHARLES O. SETHNESS, ASSISTANT SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. SETHNESS. Thank you, Mr. Chairman and Members of the Committee.

I am pleased to be here today to discuss S. 437, a Bill concerning the issue of refinancing of Small Business Administration 503 loans by certain small businesses. Under the 503 program, SBA guarantees debentures issued by certified development companies. The CDC's in turn use the proceeds of the guaranteed debentures to make loans to small businesses. Since most of the CDC debentures were purchased by the Federal Financing Bank, I would like first to discuss the FFB and its operating policies before addressing the implications of the proposed legislation.

FFB was established by the Federal Financing Bank Act of 1973 to deal with severe debt management problems arising from years of agency financing which had flooded the government securities market. These securities were financed outside the Treasury by various Federal agencies in the form of direct agency issues, sales of loan assets with Federal guarantees, and guarantees of obligations of private borrowers. Although the securities were backed by the Government, they sold at relatively high interest rates and fees. These securities also competed with Treasury securities, undermined Treasury debt management policies, created serious marketing problems, and placed Treasury in the position of being required to sanction or approve agency financings on terms which Treasury believed did not reflect the full value of the Government backing.

The proliferation of Government-backed securities in the market before the FFB was established was very costly to the Government, in part because of higher transaction costs and in part because the less competitive market for the securities resulted in higher profits to investors and investment bankers.

Now, after more than a decade of successful operations, it is widely recognized that the FFB has accomplished the stated purpose of the FFB Act of 1973, to assure coordination of federally assisted borrowing programs, to reduce the costs of Federal and Federal assisted borrowings from the public, and to assure that such borrowings are financed in a manner least destructive of private financial markets and institutions.

Presently, FFB standard operating policy permits borrowers, including CDC's, to prepay FFB loans at any time at current market

value. When FFB first started operations, prepayment was not contemplated. However, it soon became apparent that there are situations in which prepayments are programmatically necessary.

After experimenting with corporate-style prepayment provisions, FFB adopted market prepayment as the most equitable form of evaluating prepayments, both for the borrower and the taxpayer. The current market value may be more or less than the principal amount of the loan outstanding. That is, if the borrower chooses to prepay the loan before the scheduled maturity date, the borrower must pay the FFB either an amount greater than the amount of the outstanding principal, a premium, if market rates have decreased, or an amount less than the amount of the outstanding principal, a discount, if market rates have increased, and in either case plus accrued interest. Thus, the borrower is in essentially the same position as if it had issued an obligation in the market and repurchased it before maturity at the current market price. There is no economic gain or loss for either party. Both parties are only recognizing the current worth of the loan.

This standard policy for prepaying FFB loans permits the FFB to offer the borrower the lowest possible long term fixed interest rate that is guaranteed for the life of the loan, regardless of movements in market interest rates after the moneys are lent.

The FFB charges interest at the then current market yield on Treasury securities of comparable maturities, plus one-eighth of 1 percent per year to cover administrative expenses. Thus, the FFB rate is below the rate that a borrower could obtain in the private market, even with the Federal guarantee. The results of market financings under the new section 504 pilot program are a good demonstration. The interest costs on these fully guaranteed issues have exceeded yields on Treasury issues of comparable maturity by more than 100 basis points.

Without the provision for prepayment at current market value, FFB would be required to adopt the standard market practice of charging a higher interest rate at the time the loan was made to compensate for the risk of prepayment at par at a time of declining market rates. The borrower thus would incur an immediate additional cost in interest for an uncertain future benefit. In the home mortgage market, for example, interest rates for federally backed paper have been as much as two and a half percent higher than for comparable maturity Treasuries.

The interest rates and other terms and conditions, including any prepayment provisions, of the loans CDC's make to small businesses are not dictated by, nor subject to the approval of, the FFB. However, we understand that the contractual agreements between the small business borrowers and the CDC's often include prepayment provisions similar to the provisions contained in the loan agreements between the CDC's and the FFB.

S. 437 would in effect bar the CDC's from exercising existing contractual agreements with small business borrowers which provide for prepayment premiums by authorizing small businesses to prepay their borrowings from the CDC's at the outstanding principal balance, plus any accrued interest. This legislatively mandated subsidy to a very small subset of small business borrowers, however, would leave the CDC's with insufficient funds to pay the

amounts they owe to the FFB, which in turn would result in a demand for payment under the SBA guarantee.

Under current market conditions, broadening the legislation to permit par prepayment of SBA-guaranteed debentures held by the FFB would result in hidden windfall subsidies to the development companies and corresponding costs to taxpayers. Under current market conditions, the cost to taxpayers of par prepayment of FFB's holdings of 503 debentures that bear interest rates of ten percent or more would be $147.8 million on a total portfolio of loans with rates that high of $626 million. These subsidies would be provided, and costs incurred, outside of the normal budget and appropriations process. Moreover, these subsidies would be determined, not by a systematic analysis of the need of each development company and small business for subsidy, but rather by the happenstance of the relationship between prevailing interest rates at the time each debenture was issued and at the time of each prepayment. Thus, the subsidy could vary considerably from borrower to borrower, with potential for considerable inequities between borrowers in otherwise similar circumstances.

We are also concerned that allowing the section 503 development companies to prepay debentures held by the FFB at par or reduced premiums would be an open invitation to all other guaranteed borrowers to descend on Congress to demand equal treatment. Thus, the proposal would set a highly undesirable precedent that could cost the taxpayers tens of billions of dollars in foregone interest.

The FFB was created to finance federal credit programs more cheaply and efficiently than the variety of agency market financing practices used during the early 1970's. The FFB's role is to be a programmatically neutral financing mechanism for Federal credit programs. It should not be used as a policy instrument to favor one program or borrower over others, and is not intended as a subsidy program.

In view of the foregoing, the Administration is strongly opposed to S. 437.

I hope this has helped you to understand this complex issue. I will be glad to answer any questions you may have.

The CHAIRMAN. Thank you very much, Mr. Secretary.

Mr. Holloway.

Gentlemen, if you would care to summarize your statements, the Committee will welcome that and your full statement will be inserted in the record. Please proceed, Mr. Holloway.

STATEMENT OF EDWIN T. HOLLOWAY, ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT, U.S. SMALL BUSINESS ADMINISTRATION

Mr. HOLLOWAY. Thank you, Mr. Chairman. I appreciate the opportunity to appear before you today to discuss S. 437, which would amend Section 503 of the Small Business Investment Act.

As you know, pursuant to Section 503 of the Small Business Investment Act, debentures are issued to development companies certified by the SBA. These debentures are guaranteed by SBA and are purchased by the Federal Financing Bank, an organization within the Treasury Department. The funds provided by the FFB

are used to finance fixed assets for small business concerns on either a loan or a lease basis.

This amendment would permit the recipient of a loan made from the proceeds of a 503 debenture to prepay its loan by paying the outstanding principal balance due plus any accrued interest.

Since the beginning of the 503 program in 1980, FFB has required that 503 debentures contain a prepayment provision based on the yield for like maturity Treasury obligations in the marketplace on the date of the prepayment, that is, current rate.

This same provision has been included in the note evidencing the loan made to a small concern from the proceeds of a debenture. This procedure reduces the interest rate risk borne by the Treasury by permitting it to factor into its debt management definite income streams to match against its borrowing costs.

The benefit is passed through to the borrower in the form of lower interest rates. Using this procedure, there will be a premium when the current rate is lower than the rate on the 503 debenture. The premium is remitted to the Federal Financing Bank. When the current rate is higher than the debenture rate, a discount will result which is passed on to the borrower.

Although this prepayment provision may currently be troublesome to some small business borrowers and certified development companies, its existence was known to all parties at the time the loans were originated and were part of the original loan terms.

Borrowers were willing to agree to these terms because they were able to obtain funds at more reasonable terms than were otherwise available. For the borrower who wishes to prepay, an environment of uncertainty is created over loan prepayment since a borrower works with an SBA-supplied estimate of the premium or discount until 24 hours before the funds must be wire transferred to FFB.

At that point, FFB supplies the official payoff amount. This procedure can cause administrative problems for both CDC's and the SBA.

Because interest rates have fallen dramatically over the last 2 years, a premium would be required in the prepayment of any debenture that was funded prior to January 1986. The overall average premium for the FFB portfolio of $893 million of 503 debentures currently would be $136 million or 15 percent.

Currently $220 million, or 25 percent of the portfolio, would be prepayable at a discount.

Notwithstanding the prepayment provision, as of May 31, 1987, 144 borrowers have voluntarily prepaid their 503 loans with a total outstanding balance of $25.6 million. A premium was assessed on 117 loans, for a total of $3.7 million, and a discount was given on 27 loans, for a total of $456,300. The premium net of discounts was $3.2 million, or 12.6 percent.

Were this amendment to become law, we expect that loans with an interest rate of 11 percent or more would be prepaid if the borrowers were able to arrange the financing to do so. This means 51 percent of the portfolio could be prepaid.

However, we expect a smaller percentage of the portfolio to actually prepay because many borrowers will not be able to obtain the

funds to prepay their loans at par, even though they would like to do so if given the opportunity.

The distribution of the portfolio according to interest rates as of May 31, 1987, is set forth in my statement.

In the 504 program, borrowers are permitted to prepay their loans. However, there is a standard prepayment provision. A penalty during the first half of the debenture term is required. In the first 6 month period, the penalty is equivalent to 1 year of interest, and it declines to zero by the midpoint in the debenture term.

For example, a 10 year, $500,000 debenture with an 8.2 percent interest rate will have a prepayment penalty of $39,500 assessed to the borrower during the first 6 months. The penalty in the second half of the 5th year would be $4,900 and in the 6th to 10th year there would be no penalty.

In our view, there are several problems with the Bill as drafted. First, an unintended result of the present language of S. 437 could preclude the payment of any prepayment penalty, including that required under the 504 program, which was designed to be and is considered commercially reasonable.

This effect would make 504 debentures more expensive to the borrower.

Second, it would appear that CDC's, as the obligors on the debentures, could be held legally responsible for the premium payable to the FFB, but that the CDC's would be barred from collecting the premium from either the small business borrower or the SBA.

Third, the Bill would appear to prohibit prepayments at a discount, which would currently affect 25 percent of the FFB portfolio of 503 debentures.

Fourth, we are concerned that this amendment could result in large-scale prepayment of existing 503 debentures. Should this occur, it would end the servicing income to certified development companies and threaten their continued existence.

Accordingly, we cannot support the proposed legislation.

Mr. Chairman, this concludes my prepared remarks. I would be pleased to answer any questions if I can.

[The prepared statement of Mr. Holloway follows:]

SBA

U.S. Small Business Administration
Washington, DC 20416

STATEMENT OF
EDWIN T. HOLLOWAY, AA/FSI
SMALL BUSINESS ADMINISTRATION
BEFORE THE
SENATE SMALL BUSINESS COMMITTEE
UNITED STATES SENATE

JUNE 13, 1987

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY TO DISUCSS S. 437, WHICH WOULD AMEND SECTION 503 OF THE SMALL BUSINESS INVESTMENT ACT (SBI ACT). AS YOU KNOW, PURSUANT TO SECTION 503 OF THE SBI ACT, DEBENTURES ARE ISSUED BY DEVELOPMENT COMPANIES CERTIFIED BY SBA. THESE DEBENTURES ARE GUARANTEED BY SBA AND ARE PURCHASED BY THE FEDERAL FINANCING BANK (FFB), AN ORGANIZATION WITHIN THE TREASURY DEPARTMENT. THE FUNDS PROVIDED BY FFB ARE USED TO FINANCE FIXED ASSETS FOR SMALL BUSINESS CONCERNS ON EITHER A LOAN OR LEASE BASIS.

THIS AMENDMENT WOULD PERMIT THE RECIPIENT OF A LOAN MADE FROM THE PROCEEDS OF A 503 DEBENTURE TO PREPAY ITS LOAN BY PAYING THE OUTSTANDING PRINCIPAL BALANCE DUE PLUS ANY ACCRUED INTEREST.

SINCE THE BEGINNING OF THE 503 PROGRAM IN 1330, FFB HAS REQUIRED THAT 503 DEBENTURES CONTAIN A PREPAYMENT PROVISION BASED ON THE YIELD FOR LIKE MATURITY TREASURY OBLIGATIONS IN THE MARKET PLACE ON THE DATE OF THE PREPAYMENT, I.E. CURRENT RATE. THIS SAME PROVISION HAS BEEN INCLUDED IN THE NOTE EVIDENCING THE LOAN MADE TO A SMALL CONCERN FROM THE PROCEEDS OF A DEBENTURE. THIS PROCEDURE REDUCES THE INTEREST RATE RISK BORNE BY THE TREASURY BY PERMITTING IT TO FACTOR INTO ITS DEBT MANAGEMENT DEFINITE INCOME STREAMS TO MATCH AGAINST ITS BORROWING COSTS. THE BENEFIT IS PASSED THROUGH TO THE BORROWER IN THE FORM OF LOWER INTEREST RATES. USING THIS PROCEDURE, THERE WILL BE A PREMIUM WHEN THE CURRENT RATE IS LOWER THAN THE RATE ON THE 503 DEBENTURE. THE PREMIUM IS REMITTED TO FFB. WHEN THE CURRENT RATE IS HIGHER THAN THE DEBENTURE RATE, A DISCOUNT WILL RESULT WHICH IS PASSED ON TO THE BORROWER.

ALTHOUGH THIS PREPAYMENT PROVISION MAY CURRENTLY BE TROUBLESOME TO SMALL BUSINESS BORROWERS AND CERTIFIED DEVELOPMENT COMPANIES (CDCS), ITS EXISTENCE WAS KNOWN TO ALL PARTIES AT THE TIME THE LOANS WERE ORIGINATED AND WERE PART OF THE ORINGIAL LOAN TERMS. BORROWERS WERE WILLING TO AGREE TO THESE TERMS BECAUSE THEY WERE ABLE TO OBTAIN FUNDS AT MORE REASONABLE TERMS THAN WERE OTHERWISE AVAILABLE. FOR THE BORROWER WHO WISHES TO PREPAY, AN ENVIRONMENT OF UNCERTAINTY IS CREATED OVER LOAN PREPAYMENT SINCE A BORROWER WORKS WITH SBA SUPPLIED ESTIMATE OF THE PREMIUM OR DISCOUNT UNTIL 24 HOURS BEFORE THE FUNDS MUST BE WIRE TRANSFERRED TO FFB. AT THAT POINT FFB SUPPLIES THE OFFICIAL PAYOFF AMOUNT. THIS PROCEDURE CAN CAUSE ADMINISTRATIVE PROBLEMS FOR BOTH CDCS AND SBA.

BECAUSE INTEREST RATES HAVE FALLEN DRAMATICALLY OVER THE LAST TWO YEARS, A PREMIUM WOULD BE REQUIRED IN THE PREPAYMENT OF ANY DEBENTURE THAT WAS FUNDED PRIOR TO JANUARY 1985. AS A WORST CASE EXAMPLE, THE OVERALL AVERAGE PREMIUM FOR THE FFB PORTFOLIO OF $893 MILLION OF 503 DEBENTURES CURRENTLY WOULD BE $135 MILLION OR 15%. CURRENTLY $220 MILLION, OR 25% OF THE PORTFOLIO, WOULD BE PREPAYABLE AT A DISCOUNT.

NOTWITHSTANDING THE PREPAYMENT PROVISION, AS OF MAY 31, 1987, 144 BORROWERS HAVE VOLUNTARILY PREPAID THEIR 503 LOANS WITH A TOTAL OUTSTANDING BALANCE OF $25.6 MILLION. A PREMIUM WAS ASSESSED ON 117 LOANS FOR A TOTAL OF $3.7 MILLION AND A DISCOUNT WAS GIVEN ON 27 LOANS FOR A TOTAL OF $456,300. THE PREMIUM NET OF DISCOUNTS WAS $3.2 MILLION, OR 12.3%.

WERE THIS AMENDMENT TO BECOME LAW, WE EXPECT THAT LOANS WITH AN INTEREST RATE OF 11% OR MORE WOULD BE PREPAID IF THE BORROWERS WERE ABLE TO ARRANGE THE FINANCING TO DO SO. THIS MEANS 51% OF THE PORTFOLIO COULD BE PREPAID. HOWEVER, WE EXPECT A SMALLER PERCENT OF THE PORTFOLIO TO ACTUALLY PREPAY BECAUSE MANY BORROWERS WILL NOT BE ABLE TO OBTAIN THE FUNDS TO PREPAY THEIR LOANS AT PAR EVEN THOUGH THEY WOULD LIKE TO DO SO IF GIVEN THE OPPORTUNITY. THE DISTRIBUTION OF THE PORTFOLIO ACCORDING TO INTEREST RATE AS OF MAY 31, 1987, IS AS FOLLOWS:

	503 Debentures			Premium (Discount)	
Interest Rate	Number	Balances (In Millions)	% of Balance	Amount (In Millions)	%
12% - higher	1,232	$ 251	29%	$ 80.9	31%
11% - 11.9%	377	194	22%	42.6	22%
10% - 10.9%	731	171	19%	24.1	14%
Less than 10%	1,555	257	30%	(11.2)	(4%)
Total	4,595	$ 893	100%	$135.4	15%

IN THE 504 PROGRAM, BORROWERS ARE PERMITTED TO PREPAY THEIR LOANS; HOWEVER, THERE IS A STANDARD PREPAYMENT PROVISION. A PENALTY DURING THE FIRST HALF OF THE DEBENTURE TERM IS REQUIRED. IN THE FIRST 6 MONTH PERIOD, THE PENALTY IS EQUIVALENT TO ONE YEAR OF INTEREST AND IT DECLINES TO ZERO BY THE MID POINT IN THE DEBENTURE TERM. FOR EXAMPLE, A 10 YEAR, $500,000 DEBENTURE WITH AN 8.2% INTEREST RATE WILL HAVE A PREPAYMENT PENALTY OF $33,500 ASSESSED TO THE BORROWER DURING THE FIRST 5 MONTHS. THE PENALTY IN THE SECOND HALF OF THE 5TH YEAR WOULD BE $4,900 AND IN THE 6TH THROUGH 10TH YEAR THERE WOULD BE NO PENALTY.

IN OUR VIEW, THERE ARE SEVERAL PROBLEMS WITH THE BILL AS DRAFTED. FIRST, AN UNINTENDED RESULT OF THE PRESENT LANGUAGE OF S. 437 COULD PRECLUDE THE PAYMENT OF ANY PREPAYMENT PENALTY, INCLUDING THAT REQUIRED UNDER THE 504 PROGRAM WHICH WAS DESIGNED TO BE, AND IS CONSIDERED COMMERCIALLY REASONABLE. THIS EFFECT WOULD MAKE 504 DEBENTURES MORE EXPENSIVE TO THE BORROWER.

SECOND, IT WOULD APPEAR THAT CDCS, AS THE OBLIGORS ON THE DEBENTURES, COULD BE HELD LEGALLY RESPONSIBLE FOR THE PREMIUM PAYABLE TO THE FFB BUT THE CDCS WOULD BE BARRED FROM COLLECTING THE PREMIUM FROM EITHER THE SMALL BUSINESS BORROWER OR THE SBA.

THIRD, THE BILL WOULD APPEAR TO PROHIBIT PREPAYMENTS AT A DISCOUNT, WHICH WOULD CURRENTLY AFFECT 25% OF THE FFB PORTFOLIO OF 503 DEBENTURES.

FOURTH, WE ARE CONCERNED THAT THIS AMENDMENT COULD RESULT IN LARGE-SCALE PREPAYMENT OF EXISTING 503 DEBENTURES. SHOULD THIS OCCUR, IT WOULD END THE SERVICING INCOME TO CDC'S AND THREATEN THEIR CONTINUED EXISTENCE.

ACCORDINGLY, WE CANNOT SUPPORT THE PROPOSED LEGISLATION.

MR. CHAIRMAN, THIS CONCLUDES MY PREPARED REMARKS. I WOULD BE PLEASED TO ANSWER ANY QUESTIONS YOU MAY HAVE.

QUESTIONS FROM SENATOR BUMPERS AND ANSWERS BY MR. HOLLOWAY

Question #1: You have explained that "an environment of uncertainty" surrounds the borrower when a prepayment is being considered and that the amount of the penalty is not determinable until the last 24 hours prior to the transfer. Can you explain why this uncertainty exists?

a. What role does SBA plan in the prepayment scheme?

Response: The uncertainty as to the amount of the penalty is the result of the FFB requirement that the prepayment amount be based on interest rates in effect 2 days before the prepayment date. For example, let us assume that a prepayment is scheduled to take place on a Thursday. It is our understanding that the FFB uses the interest rate as of the close of business Tuesday. That rate is not available until Wednesday morning at which time FFB calculates the prepayment amount. FFB must receive that exact amount of money by the close of business on Thursday or they have the right to terminate the transaction.

Because the amount is not known by anyone before the day prior to the prepayment date, it is often difficult for the borrower to make arrangements for the prepayment.

a. SBA's role in the prepayment process is twofold. First, it serves as FFB's agent in dealing with the CDC. Secondly, SBA acts to protect its interest in the financing by making sure that all arrearages are paid prior to releasing lien documents. SBA is responsible for receiving notification of intent to prepay, notifying FFB, receiving Notice of the amount from FFB, and notifying the CDC and borrower of the amount required to prepay.

Question #2: In referring to the 504 prepayment plan in your statement, which is vastly different from the 503 penalty provisions, you said that the 504 penalty is considered to be "commercially reasonable." Are you not inferring that the FFB's penalty provision for 503 prepayment is unreasonable? Isn't it unreasonable in light of the commercially acceptable prepayment requirements placed on commercial loans?

Response: When we developed the 504 program, the underwriters wanted a standard prepayment penalty. Their position was that the prepayment provision in the 503 program is not commercially practical because investors do not want to be exposed to uncertainty.

Question #3: You've indicated that about 51% of the 503 portfolio could be prepaid if the borrowers were able to find the financing to do so, but that it is not likely that many would be able to find that financing.

a. If the borrowers were able to obtain the financing under the 504 program, would that not facilitate the prepayment process and further eliminate the possibility the SBA guarantee might have to be invoked?

b. Would SBA support NADCO's proposal to allow the borrower to obtain 504 financing following prepayment of his 503 loan at par?

c. Wouldn't this transfer of financing to the 504/private sector initiative program be consistent with the Administration's desire to roll the rest of the 503 program into the 504 program?

Response: a. Insofar as the fact that the reduction in interest rate would decrease the chances of a borrower being unable to make payments the answer is yes, potential reduction of SBA's guarantee exposure is a distinct possibility.

b. SBA would support the NADCO proposal to allow refinancing via the 504 mechanism so long as the existing loan guarantee is transferred. SBA's preference is that the costs of funding under 504 be paid by the borrower out of pocket.

c. It would not be inconsistent with the Administration's desire to rely on the private sector.

Question #4: How can SBA refuse to support a proposal that would allow the small business borrower to prepay his 503 loan at par while, under the FY 88 budget proposal, the agency suggests selling the 503 loan assets at only 49 cents on the dollar, far below par?

Response: The FY 1988 budget proposes loan asset sales for its disaster, business, and 503 loan programs. The receipt figures contained in the document were developed to be conservative, and to reflect the expected return that could be realized from such sales of government assets to third parties. Included in these estimates are provisions for (1) the average maturity, interest rate, and repayment terms and, therefore, expected cash flows of the portfolios, (2) historical losses and anticipated loss rates, (3) future servicing costs, and (4) current market trends on sales of assets. Therefore, a comparison of the budget proposal of borrower prepayment of 503 loans is not valid.

Question #5: Why does SBA, along with the Treasury Department, support the prepayment of disaster loans (of $5,000 or less) made to homeowners, which is a type of refinancing, but not the prepayment of 503 loans?

Response: The disaster loans are a tremendous administrative burden because of the small dollar amount of each loan, the low interest rate, and the widely geographically dispersed nature of the loans. As a result, it is more cost effective because the government can actually save money by selling this expensive portfolio to a logical purchaser, the borrower.

Question #6: Mr. Holloway, isn't it true that, in the event of default, SBA is required to pay the same prepayment penalty as would be paid by a small business person desiring to prepay?

a. So, as compared with prepayment provisions under Secton 504, the 503 prepayment penalties are rather costly for SBA, are they not? Have you made any estimates what these prepayment penalties have cost over the life of the program?

b. SBA's funding for these prepayment penalties has been provided for in appropriations, has it not? So, in effect, Congress is simply taking money from one pocket and putting it in another, is it not?

Response: a. Yes, the same prepayment terms that apply to a small business borrower also apply to SBA if it purchases a debenture in the exercise of its guarantee.

As of May 31, 1987, SBA had repurchased 44 debentures with a remaining principal balance at the time of purchase of $8,293,334. None of the debentures were able to be purchased at a discount; SBA's total premium cost was $1,506,657.

b. It would seem so.

The CHAIRMAN. Thank you very much, Mr. Holloway.

Secretary Sethness, let me say that I think you make a fairly plausible argument, the sauce for the goose, sauce for the gander argument, that if interest rates go up the borrower has a chance to come in and take a discount and get the benefit of paying it off because his interest rate is lower than the prevailing market rates.

Is that not your argument, essentially?

Mr. SETHNESS. That is part of the argument, yes, sir.

The CHAIRMAN. And I think there is some merit to that. And then Mr. Holloway says 144 borrowers have already prepaid their 503 loans, which had a balance of $25.6 million, and a premium was assessed on 117 loans, for a total of $3.7 million, and a discount given on 27 loans.

Now, would it be equitable if this Bill had a provision in S. 437 which would require that we would pay back the $3.7 million in premiums that these people have paid, these 144 borrowers that had already paid theirs off? That is, if they had waited and this Bill passed, they would not have to pay.

Are you following me on that?

Mr. SETHNESS. I am following you on that. The difficulty I am having with it is that I do not think it is reasonable to let people——

The CHAIRMAN. I do not think it is, either.

Mr. SETHNESS. And to then have that trigger an equitability argument that could track back through any number of FFB borrowers who have paid off their loans with prepayments could produce some quite unanticipated results that may be well outside of this $3.7 million.

The CHAIRMAN. Well, you state, Secretary Sethness, that this Bill would cost the Federal Government $148 million.

Mr. SETHNESS. Yes, sir, if all of the borrowers who have loans at 10 percent or more would prepay.

The CHAIRMAN. Well, let me go ahead with that. Why is it that this Administration opposes this Bill on the grounds that it is going to cost $148 million, and last year you were wanting to liquidate these loans for 49 cents on the dollar?

Mr. SETHNESS. The loan asset sales program has a couple of multiple functions to it. One of the things that you do, that we were proposing to do and continue to propose to do in loan asset sales, is that as the loans are sold the credit risk to the Government is also shed. We are out of that loan completely.

The CHAIRMAN. Your risk is also eliminated with this Bill. There is a guarantee provision. I mean, the Government is guaranteeing these debentures.

Mr. SETHNESS. Yes, that is true.

The CHAIRMAN. Let us just admit it. It is a contradiction, is it not?

Mr. SETHNESS. There are some difficulties in threading the needle. It is not a total contradiction. You do also shed some servicing responsibilities. You identify the subsidies that were inherent in your loan in the first place.

And the experience to date in the programs that have worked aggressively at selling their loans has in fact produced some very useful improvements in their credit management, just because they

found out what they were and were not doing with their loan portfolio.

The CHAIRMAN. Tell me precisely, what is the prepayment penalty in the 503 loans? How much is it?

Mr. SETHNESS. It depends on the rate at which the loan was taken out. The prepayment penalty or premium——

The CHAIRMAN. But it essentially says that if you paid this loan off, you have got to pay the next 5 years' interest in order to pay it off, do you not?

Mr. SETHNESS. No, you pay the present value of that interest, at the current cost of money.

The CHAIRMAN. Walk through a cost with me on that. I am a little unclear on that.

Mr. SETHNESS. Essentially what this is is that if you are paying off the loan today—well, let me make some assumptions. There is a 14 percent interest rate on a $100,000 loan and current interest rates——

The CHAIRMAN. What interest rate?

Mr. SETHNESS. 14 percent on a $100,000 loan, and current interest rates are at 9 percent. Over the next 5 years, the difference between 14 percent and 9 percent, or 5 percent a year, is going to be the cost. That cost number is calculated as a present value of those five $5,000 pieces.

The CHAIRMAN. Do you further discount it on the basis that the Government is going to have the use of that 5 percent differential over the next 5 years?

Mr. SETHNESS. What the Government has the use of? Oh, no.

The CHAIRMAN. You do not give them any interest on the what they are paying?

Mr. SETHNESS. We have not further discounted for the penalty amount.

The CHAIRMAN. How does that compare with prepayment penalties in the private sector?

Mr. SETHNESS. Prepayment penalties in the private sector are not normally worked out on this basis.

The CHAIRMAN. This is pretty stringent. It is a pretty stringent prepayment penalty, is it not?

Mr. SETHNESS. It is a theoretically pure prepayment penalty, as the cost of getting the theoretically absolutely cheapest money that you could get at the time you got it. If we had corporate-style prepayment provisions, in my view the FFB would have to revise its lending rates upwards to cover the risk that you would have adverse prepayment experience.

People tend to only prepay when it is really to their benefit to do so, and we would have to raise interest rates at the front end to cover ourself for a different prepayment——

The CHAIRMAN. If this Bill passes, you are going to have to raise the interest rates?

Mr. SETHNESS. Yes.

The CHAIRMAN. I understand that argument and I think it is a valid one.

But let us walk through the other side now. We walked through a hypothetical case a moment ago where interest rates are less now than they were then. Let us walk through the other side and let us

assume that the borrower is paying 14 percent on his loan. He can go get, to make it easy, 10 percent, he can go get the same loan at 10 percent now—no, wait a minute.

Mr. SETHNESS. Rates have to go to 20 percent.

The CHAIRMAN. I want to go to the other case, where interest rates are 19 percent on a 14 percent loan. So how do you figure his discount? If he wants to come in and pay it off, what kind of a discount are you going to give him?

Mr. SETHNESS. You are going to discount the same $5,000, but it is going to be——

The CHAIRMAN. You mean the 5 percent?

Mr. SETHNESS. The 5 percent. But you are going to discount that back as a deduction from what he owes.

The CHAIRMAN. So you treat it exactly as you do the other way?

Mr. SETHNESS. Completely parallel.

The CHAIRMAN. I have four cases here which I want to insert in the record.

The first is, the company name is Glenn Design Co.; the second is California Sample Furniture Co.; the third one is Spacesonics, Inc., of Menlo Park, CA; and the fourth one is World Tire Corp. And I will insert these in the record.

[Material follows:]

Company Name: Glenn Design Company

Address: 819 Bridgeway
Sausalito, CA 94965

Original Loan Amount: $500,000

Interest Rate: 14.67%

Current Balance: $489,621

Estimated
Prepayment Penalty: $116,000

Comments:

Company Name: California Sample Furniture Company

Address: 935 Texas Street
Fairfield, CA 94533

Original Loan Amount: $330,000

Interest Rate: 14.67%

Current Balance: $323,402

Estimated
Prepayment Penalty: $ 80,000

Comments:

Company Name: Spacesonics, Inc.

Address: 110 Constitution Drive
Menlo Park, CA 94025

Original Loan Amount: $443,000

Interest Rate: 12.637%

Current Balance: $434,789

Estimated
Prepayment Penalty: $215,724

Comments:

Company Name: World Tire Corporation

Address: 4435 South 13th Place
Tukwila, WA 98188

Original Loan Amount: $458,000

Interest Rate: 15.056%

Current Balance: $444,600

Estimated
Prepayment Penalty: $195,647

Comments:

The CHAIRMAN. But just for the questioning, for the purpose of this question, Mr. Secretary, the original loan amount for World Tire Corp. is $458,000 and the interest rate was 15.056 percent. Their current balance is $444,600, and it is estimated that if they want to pay that loan off today they would have to pay a penalty of $195,000, almost 50 percent of the unpaid balance.

Mr. SETHNESS. That sounds right at a 15 percent original rate compared to today's rate. That is how the application of that formula would work out.

The CHAIRMAN. Is there any middle ground between your position now and Senator Metzenbaum's proposal?

Mr. SETHNESS. If there were a middle ground, Senator, I think you would have to apply it going forward rather than retroactively. We could develop an alternative approach to prepayment and then charge higher interest rates. But I do not see any alternative that reduces the prepayment premium today and leaves people with the benefit of the interest rates they had over the previous 5 years.

The CHAIRMAN. There is something sort of inequitable about the way you are handling this. I understand the argument on a pure economic basis, just a pure financial basis. I understand the argument.

But it seems to me that this is just almost punitive in nature. In comparison, the interest rate on my house is 8.5 percent and originally, as interest rates began to decline I just thought, you know, as interest rates are going down to 8 percent, I will go refinance that house.

And I do not believe I have a prepayment penalty. I do not think there is a prepayment penalty for the mortgage on my home

Mr. SETHNESS. That is true, and this is part of our problem in arguing our case, I grant you. Everybody uses the home mortgage analogy, and I suspect that when you took out your 8.5 percent loan the FFB loan formula probably would have produced a loan for you at 6 percent or less.

The CHAIRMAN. Where were you when I needed you?

Mr. SETHNESS. Well, maybe that was not a small business fixed asset purchase, Mr. Chairman.

And if—as I said, if we were to provide for prepayment at any time the way home mortgages do, we would have to charge considerably higher interest rates at the front end.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Well, as a matter of fact, Mr. Secretary, it is relatively uncommon to have prepayment penalties in private sector loans with financial institutions, is it not?

Mr. SETHNESS. No, it is not uncommon at all, sir.

Senator DIXON. In my own personal experience, every loan I have ever negotiated with a financial institution, we have been able to arrange a prepayment agreement so that I never had to pay any penalty on any private sector loan.

Mr. SETHNESS. Loans to individuals tend not to have much in the way of penalties. I do know that when I took out my 17 percent mortgage, which I prepaid later, I had to pay one point.

Senator DIXON. Well, on CD's I paid some kind of a penalty on cashing them in prematurely. My recollection is that that has occurred. Nothing like the type of penalty you folks exact.

I am trying to figure out, how do you figure out the interest rate in the succeeding years? I understand what you would do on a current basis, but how do you extrapolate that over a period of years if a person wants to prepay a loan 5 years before it comes due, in the case you were giving to the Chairman?

Mr. SETHNESS. We use the then current rate for the remaining average maturity of the loan.

Senator DIXON. I happen to be a co-sponsor of this Bill, but notwithstanding that fact it occurs to me that the penalty you exact is a very harsh one. And I would urge you to consider the value of the point made by the Chairman, that we try to find some ground that might be some intermediary type of position that would be agreeable to the Administration as well as the sponsors of this legislation.

It does seem to me that the penalty is very, very harsh.

Mr. SETHNESS. The penalty is as harsh as the interest rate was low when the loan was first taken out. The alternatives for people who borrowed the 14 percent money were probably in excess of 20 percent at that time.

Senator DIXON. But to pursue that argument would be to suggest that you did not make money off the loan. But you did. You made the current rate off the loan at the time that the loan was made, and for those periods of years that the interest payments were made you were receiving the current market value.

Mr. SETHNESS. Senator Dixon, would you argue that if rates do go back up some significant amount that we ought to revise upward the rates on the loans in the portfolio? I presume not.

Senator DIXON. Well, I would not argue that. But I would argue that in many cases private sector financial institutions enter into lending agreements in which there is no prepayment penalty at all.

Mr. SETHNESS. And they charge for it.

Senator DIXON. I do not think either the Chairman or myself is suggesting that there might not be some impact upon the interest rate in a different kind of arrangement from the kind of arrangement you have now, with the penalty arrangement that you have.

Mr. SETHNESS. With hindsight, Senator, I wish we had at least made that kind of option available to all of these people back at that time. And if they had then said we would rather not have your 18 percent prepayable money, we will take the 15 percent market prepayment penalty money, then we would not be having this discussion, because they would have made a free choice against the kind of alternative that you want.

Unfortunately, we did not have hindsight at the time and we did not set it up that way.

Senator DIXON. I do not think I am arguing that there ought not to be any penalty, you understand, Mr. Secretary. I think that there is some reasonable type of agreement that could be achieved here that would provide a reasonable penalty for a prepayment arrangement.

But it seems to me that to charge, in effect, the entire amount that the Government would realize in requiring that the person conform to the full agreement throughout the entire period of the loan is a rather harsh penalty.

Mr. SETHNESS. Well, one quick calculus I did in my head last night is that—I hear your point, sir, and we will certainly consider it and think about it and see whether there is some way that we can get ourselves comfortable with something else.

I am dubious of the ability to get there, but we will give it a try. If you do one very notional set of numbers and say that they would have had to pay 3 percent more for their money if we had had no prepayment or limited prepayment premium, they have had the loan outstanding for 5 years, we have lost 15 percent. And you add 1 year's interest and you come up with a 30 percent premium, which is not all that different from what we have now.

It is hard to get to equity.

[Material follows:]

QUESTIONS FROM SENATOR BUMPERS AND ANSWERS BY MR. SETHNESS

1. When the section 503 plan was instituted in 1981, was it not the Treasury Department's original intent to sell the 503 debenture portfolio in the private capital markets? If so, why has Treasury decided to do otherwise?

A. It was not the original intention of the Treasury Department to sell the fully guaranteed 503 debentures in the private capital markets.

2. Why does the Treasury Department, along with SBA, support prepayment of disaster loans (of $5,000 or less) made to homeowners, which is another type of refinancing, but not prepayment of 503 loans?

A. The disaster loans typically bear below market interest rates. Permitting low interest rate loans to be prepaid at a discount is completely consistent with the market prepayment provision in the FFB loan contracts.

3. Under the FFB prepayment formula, is it not possible that two different borrowers with identical loans and terms could be required to pay substantially different penalties depending on the date at which they attempt prepayment?

A. Strictly speaking, the FFB does not charge a penalty. Rather it charges the present value that is based on current market rates of interest. This present value represents the difference between the interest rate on the obligation and the current cost of funds for a loan with a similar maturity. Costs of funds change on a daily basis based on market movements. Therefore it is possible for the same loan to be repayable at different prices on different dates depending on the current cost of funds.

4. Does the purpose of the penalty still hold true if the borrower would like to refinance under the 504 program?

a. What do you think of NADCO's proposal to offer 504 financing to the 503 borrower who repays his loan at par?

A. If the borrower is allowed to prepay the 503 debentures at par there is a loss to the taxpayer that is equal to the foregone market premium. If the source of funds for refinancing at par is fully government guaranteed as suggested above, the taxpayer is further disadvantaged by retaining the liability for a potential borrower default. Therefore the prepayment premium should still be required if the borrower

refinances in the 504 program. (Prepaying at par from a fully guaranteed refinancing is the economic equivalent of a straight interest rate buy-down -- and has the additional disadvantages of higher interest cost to the borrower and more U.S. government paper in the market competing with and raising the cost of Treasury securities.)

5. Mr. Secretary, you observed that financing through the FFB had, in the past, produced the lowest available cost on long-term, fixed rate financing for the CDC's and small business, and you commented that rates in the new section 504 "off budget" financing has produced interest rates, according to you, of about 100 basis points higher than the comparable Treasury rate.

However, the 504 instruments contain a prepayment provision much more reasonable from the borrower's standpoint. The 504 program seems to be doing well, and there have been no complaints from either borrowers or investors about prepayment penalties. Did it occur to you that borrowers might be willing to pay a slightly higher rate in order to get a reasonable prepayment provision?

A. As I stated in my testimony, the Section 504 market financings have carried interest rates of at least 100 basis points over comparable Treasury securities. As I discussed in the question and answer period after my testimony, it may be possible for FFB to offer a 504 style prepayment provision for future borrowings and that this extra provision would require that a higher interest rate be charged on those borrowings.

The 504 program began operation in January of this year. I understand that there have been no prepayments to date, both because of the newness of the program and because interest rates have not declined.

I also understand that the basic motivation of the 504 program was to avoid the FFB so as to achieve the current "off budget" treatment. The Administration believes that its Credit Reform proposals, which would provide equivalent budget treatment for direct and guaranteed loans, would be an important step toward better evaluation and efficiency of government credit programs.

The CHAIRMAN. Mr. Holloway, one question of you. What has been the default rate on these loans?

Mr. HOLLOWAY. Mr. Chairman, the default rate has been relatively low on these loans. I will furnish a precise figure for the record.

The CHAIRMAN. Please do that.

[Material follows:]

6-19-87

Honorable Dale Bumpers
Chairman
Committee on Small Business
United States Senate

Dear Mr. Chairman:

This is in response to your request of June 18, 1987, during the hearing on S.437 regarding the default rate on Small Business Administration section 503 loans.

Recent studies indicate that there is a default rate of 3.5 percent in the number of loans and a default rate of 3.4 percent of the dollar amount outstanding.

We will be happy to provide any additional information the Committee may require.

Sincerely,

/s/

Cliff Bowman
Acting Assistant Administrator
for Congressional & Legislative Affairs

The CHAIRMAN. Is the Government currently making money on these, given the default rate? Is the Government making money on these loans?

Mr. HOLLOWAY. Senator, I would not say that the Government is making money. I would only say that our experience with defaults has been satisfactory from a program administration point of view.

The CHAIRMAN. So you do not want it tinkered with.

Senator Pressler, do you have any questions of these gentlemen?

Senator PRESSLER. Mr. Chairman, I do have an opening statement I would like to make later.

The CHAIRMAN. That would be fine. I stated at the opening that any Senator who has an opening statement may insert them in the record at any time. Or if you would like to deliver it, we will allow you to do that.

Gentlemen, thank you very much.

Senator Metzenbaum.

Senator Metzenbaum, this is your legislation we are holding this hearing on. We are very pleased to have you with us this morning, and we are very happy that you could be here and we are anxious to hear your testimony.

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator METZENBAUM. Thank you very much, Mr. Chairman. I say to you that I am normally not late for meetings, but as I explained to you, I had to make another commitment.

I want to thank you for scheduling today's hearing on S. 437. It is a Bill I introduced along with Senators Dixon, Inouye, Matsunaga, Burdick, Daschle, and Conrad. And at the place where we put the names in, I want to share with the Chairman and Senator Pressler that there is room for just two more names.

This legislation would remedy a serious problem with the SBA 503 loan program. But let me address myself to these men who appeared here this morning.

First of all, I do not really believe that those are their views. I believe that they were prepared to come here and support this legislation until the Administration said to them no. The OMB said no. The Budget Director, the Office of Management and Budget Director, who was able to find $500,000 to refurbish the Gold Room in the Executive Office Building, *that* he could find. And he is prepared to go forward and spend another $500,000 to refurbish other rooms.

But when it comes to people such as small business people, this Administration has a cold, crass, and indifferent attitude. It is interesting to me. There has not been one word raised by the Administration, nor by the Republican Members of the U.S. Congress, about the fact that there is an $8 billion give-away, if that is what they are talking about, if this is a give-away, for the rural electrification and power operations, because they are doing exactly the same thing that they will not let the small business people of this Country do.

That is in the budget bill. That is going to come before the Floor. That has passed the U.S. Senate. The Administration has not said a word about it.

Maybe the difference is that those who get rural power are a larger constituency than the small business people of this Country. But that program cost 56 times more than this $147 million.

And I reject as absurd the suggestion that they would have to raise their rates. The SBA is not a profit-making operation. The SBA takes many losses. The Government understands that. They do not operate on a profit-making basis, and when they make a profit they do it by squeezing the small business people who needed loans at a time when they were starting their businesses or when they were going forward with their businesses and had to pay these exhorbitantly high rates.

The SBA loan program was established to provide long term financing for small businesses. Since the first loans were awarded in 1981, nearly 5,000 businesses nationwide have received more than $800 million in loans. The SBA-guaranteed loan typically represents only 40 percent of the entire loan package, with the remainder coming from commercial lenders and the business itself.

Therefore, the program has been responsible for the generation of nearly $2 billion in small business expansion. I do not have to say to this Chairman and this Committee that there are more new, innovative ideas, more new employment, coming from the small business communities, the small businesses of this Country, than all the big business operations.

And we need that small business innovation. We need that new employment. And the SBA program is a tremendous success, and it is a tribute to government-private sector cooperation.

In my State of Ohio, the 503 loan program has a proven track record. Over 600 businesses have received more than $100 million in loans. In Cincinnati alone, these loans have been responsible for almost $45 million in development and the creation and retention of 3400 jobs. And there are business people who are here from Cincinnati this morning to address themselves to this issue.

Mr. Chairman, as successful as the 503 program has been, many businesses are now being penalized by the very program that assisted them in the past. Those businesses which took out loans when interest rates were in double digits can now find substantially lower rates from commercial lenders. However, when they want to pay off the SBA loans in order to secure commercial refinancings, they are required to pay exhorbitant prepayment penalties on the federal portion of the loan package.

These penalties are running about 30 to 40 percent of the outstanding loan balance, 30 to 40 percent. The Chairman mentioned one that was about 50 percent. Thus, these businesses are stuck paying back loans at interest rates that are substantially higher than the going market rate.

What did these people from the Small Business Administration say when they testified? This may be troubling to borrowers. I should say it is troubling. No other sector of the economy, no banks, exact that kind of prepayment penalty with respect to business loans or homeowner loans.

There is a prepayment penalty in some instances of two percent, three percent, or four percent. But the Government is not satisfied with that. We have got the small business people over the barrel. We are really going to extract the last buck from them.

And they are not really powerful enough as a lobby to have any impact upon this Administration. So the Administration says: The devil with you; we will take care of the rural electrification and power cooperatives, but we will not take care of you.

I have no quarrel about what they have done with the rural electrification cooperatives. What I do say is, what is goose for the gander, or whatever the phrase is. [Laughter.]

The CHAIRMAN. It is what is goose for the sauce. [Laughter.]

Senator METZENBAUM. One Cincinnati businessman told me that to pay off the remaining $286,000 of his loan he must come up with an additional $130,000. That is a 45 percent prepayment penalty. He calls that abusive. So do I.

An owner of two lighting stores in Cleveland told me that he wants to open a third store, but is unable to because he cannot afford to pay off his SBA 503 loan. He said if the prepayment penalty were lifted he would open the extra store immediately.

New jobs, more money in the economy. Plus, in this case the prepayment penalty has literally prohibited him from expanding. This situation, Mr. Chairman, is absurd. We cannot allow it to continue.

My bill allows businesses to repay their loans earlier without incurring exhorbitant prepayment penalties. In many cases, the commercial lenders involved in the 503 loan package have permitted prepayment or have negotiated refinancing at a lower rate.

The Federal Government, however, has refused to renegotiate the terms of its portion of the loan. The bill simply enables the Federal Government to operate the 503 loan program with the same degree of flexibility as a commercial lender.

Mr. Chairman, I say to the SBA and I say to the Administration: Shame on you; are you not embarrassed to be taking this position against small business people in this Country?

This Administration, which would like to view itself as being compassionate and humane and caring, this Administration, which would say that it is a friend of people in business, now says that you have to pay a 45 percent, 50 percent, 30 percent prepayment penalty.

I say I cannot believe that the President supports this position. I believe that those who play with the figures and those who make policy while he has other matters on his mind, I believe they are making the policy.

I hope that your Committee will see fit to act promptly on this legislation. I feel confident that if it comes to the Floor we can pass it overwhelmingly on behalf of the small business people of this Country.

Thank you, Mr. Chairman.

[The prepared statement of Senator Metzenbaum follows:]

U.S. Senator Howard M.
METZENBAUM
of Ohio

Committees:
Judiciary
Labor and Human Resources
Energy and Natural Resources
Select Committee on Intelligence

Chairmanships:
Subcommittee on Antitrust
Subcommittee on Labor
Subcommittee on Energy
Regulation and Conservation

TESTIMONY OF SEN. HOWARD M. METZENBAUM
SENATE SMALL BUSINESS COMMITTEE HEARING ON S.437, JUNE 18, 1987

MR. CHAIRMAN, THANK YOU FOR SCHEDULING TODAY'S HEARING ON S.437, A BILL I INTRODUCED ALONG WITH SENATORS DIXON , INOUYE, MATSUNAGA, BURDICK, DASCHLE, AND CONRAD, TO REMEDY A SERIOUS PROBLEM WITH THE SBA 503 LOAN PROGRAM.

THE SBA 503 LOAN PROGRAM WAS ESTABLISHED TO PROVIDE LONG TERM FINANCING FOR SMALL BUSINESSES. SINCE THE FIRST LOANS WERE AWARDED IN 1981, NEARLY 5,000 BUSINESSES NATIONWIDE HAVE RECEIVED MORE THAN $800 MILLION IN LOANS. THE SBA-GUARANTEED LOAN TYPICALLY REPRESENTS ONLY 40% OF THE ENTIRE LOAN PACKAGE, WITH THE REMAINDER COMING FROM COMMERCIAL LENDERS AND THE BUSINESS ITSELF. THEREFORE, THE PROGRAM HAS BEEN RESPONSIBLE FOR THE GENERATION OF NEARLY $2 BILLION IN SMALL BUSINESS EXPANSION.

ITS TREMENDOUS SUCCESS IS A TRIBUTE TO GOVERNMENT-PRIVATE SECTOR COOPERATION.

IN MY STATE OF OHIO, THE 503 LOAN PROGRAM HAS A PROVEN TRACK RECORD. OVER 600 BUSINESSES HAVE RECEIVED MORE THAN $100 MILLION DOLLARS IN LOANS. IN CINCINNATI ALONE, THESE LOANS HAVE BEEN RESPONSIBLE FOR ALMOST $45 MILLION IN DEVELOPMENT AND THE CREATION AND RETENTION OF 3,400 JOBS.

MR. CHAIRMAN, AS SUCCESSFUL AS THE 503 PROGRAM HAS BEEN, MANY BUSINESSES ARE NOW BEING PENALIZED BY THE VERY PROGRAM THAT ASSISTED THEM IN THE PAST. THOSE BUSINESSES WHICH TOOK OUT LOANS WHEN INTEREST RATES WERE IN DOUBLE DIGITS CAN NOW FIND SUBSTANTIALLY LOWER RATES FROM COMMERCIAL LENDERS. HOWEVER, WHEN THEY WANT TO PAY OFF THE SBA LOANS IN ORDER TO SECURE COMMERCIAL REFINANCING, THEY ARE REQUIRED TO PAY EXORBITANT PRE-PAYMENT PENALTIES ON THE FEDERAL PORTION OF THE LOAN PACKAGE. THESE PENALTIES ARE RUNNING ABOUT 30-40% OF THE OUTSTANDING LOAN BALANCE. THUS, THESE BUSINESSES ARE STUCK PAYING BACK LOANS AT INTEREST RATES THAT ARE SUBSTANTIALLY HIGHER THAN THE GOING MARKET RATE.

MR. CHAIRMAN, THE SBA SHOULD BE A SMART LENDER, NOT A LOAN SHARK.

ONE CINCINNATI BUSINESSMAN TOLD ME THAT TO PAY OFF THE REMAINING $286,000 OF HIS LOAN, HE MUST COME UP WITH AN ADDITIONAL $130,000. THAT IS A 45.7% PRE-PAYMENT PENALTY; HE CALLS THAT "ABUSIVE," AND SO DO I.

AN OWNER OF TWO LIGHTING STORES IN CLEVELAND TOLD ME THAT HE WANTS TO OPEN A THIRD STORE, BUT IS UNABLE TO BECAUSE HE CANNOT AFFORD TO PAY OFF HIS 503 LOAN. HE SAID THAT IF THE PRE-PAYMENT PENALTY WERE LIFTED, HE WOULD OPEN THE EXTRA STORE IMMEDIATELY. THUS, IN THIS CASE, THE PRE-PAYMENT PENALTY HAS LITERALLY PROHIBITED HIM FROM EXPANDING.

THIS SITUATION IS ABSURD, AND WE CANNOT ALLOW IT TO CONTINUE.

MY BILL ALLOWS BUSINESSES TO REPAY THEIR LOANS EARLY WITHOUT INCURRING EXORBITANT PRE-PAYMENT PENALTIES. IN MANY CASES, THE COMMERCIAL LENDERS INVOLVED IN THE 503 LOAN PACKAGE HAVE PERMITTED PRE-PAYMENT OR HAVE NEGOTIATED REFINANCING AT A LOWER RATE; THE FEDERAL GOVERNMENT, HOWEVER, HAS REFUSED TO RENEGOTIATE THE TERMS OF ITS PORTION OF THE LOAN. MY BILL SIMPLY ENABLES THE FEDERAL GOVERNMENT TO OPERATE THE 503 LOAN PROGRAM WITH THE SAME DEGREE OF FLEXIBILITY AS A COMMERCIAL LENDER.

AGAIN, I THANK YOU FOR SCHEDULING THIS HEARING, AND I LOOK FORWARD TO WORKING WITH YOU AND THE OTHER MEMBERS OF THE COMMITTEE TO MAKE THE FEDERAL GOVERNMENT MORE RESPONSIVE TO THE NEEDS OF SMALL BUSINESS.

The CHAIRMAN. Thank you, Senator Metzenbaum.

If I may deviate slightly from the protocol normally adhered to in this Committee, Secretary Sethness, can we ask you from where you are sitting right now, I take it that in your position that you also have jurisdiction over the borrowing by the REA, do you not?

Mr. SETHNESS. Yes, sir.

The CHAIRMAN. Could you tell me what the Administration's official position is on this proposal that is now in the budget?

Mr. SETHNESS. I would be happy to, and I have the letter from the Director of the Office of Management and Budget to Senator Chiles strongly protesting doing this as something that is absolutely wrong to do.

[Material follows:]

Sent Memo
Gene Nelson
FYI

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON D.C. 20503

MAY 21 1987

Honorable Lawton Chiles
United States Senate
Washington, D. C. 20510

Dear Lawton:

I am writing to advise you of Administration opposition to a policy assumption in the FY 1988 Senate Budget Resolution involving premium free prepayment of Federal Financing Bank (FFB) loans made to rural electrification and telephone systems. Presumably borrowers would be authorized to use a privately originated loan for prepayment with a 100 percent guarantee by REA.

Specific proposals based on this approach have also been sponsored by Senator Exon (S. 912) and have been included in the Senate Supplemental Appropriations bill (H.R. 1827). Both are also opposed by the Administration.

The Senate Budget Committee estimates the FY 1988 Budget Resolution policy assumption to result in $7.2 billion in premium free refinancing of long-term REA guaranteed FFB loans. This would mean that the U.S. taxpayer would lose up to $2 billion in prepayment premiums that the borrowers contractually agreed to pay when their loans were originally made. This giveaway would go to borrowers who are financially sound with absolutely no compensating benefit in return for the taxpayer. This would be in addition to the $2.0175 billion in premium free prepayments required in FY 1987 under the "Omnibus Budget Reconciliation Act of 1986" that are being made available to financially troubled borrowers. In light of the severe budget constraints that currently face us, we should be looking to reduce and not increase subsidies to the already heavily subsidized REA borrowers.

The $7.2 billion in loan prepayment receipts that are estimated to occur in FY 1988 from the program would be a one time receipt that will result in lower future year receipts making the effort to balance the budget by FY 1991 all the more difficult.

Further, one reason this approach has become attractive to some members is because of the purported

budget savings that occur with prepayments. However, these so called savings occur without lower program costs or lower risk to the Federal Government. REA would continue to provide a 100 percent guarantee of the private loan and the private lender would assume absolutely no risk on interest or principal payments. REA would continue to be responsible for assuring payment to the private lender should a borrower default on a loan. Therefore, the so called budgetary savings are entirely illusory.

Overall, REA borrowers have been given over $50 billion in economic subsidies by REA since CY 1973. This does not include the benefits that many borrowers receive as a result of being exempt from Federal income tax. The nearly $2 billion provided by this proposal would be additional subsidies at a time when the Nation's spending and budget deficit must be reduced. REA borrowers as a group are in excellent financial condition and need to rely far more on private credit. The original goals of the REA program have been largely accomplished. Today, 99 percent of all rural areas have electric service and 96 percent have telephone service. It is time most REA borrowers recognize that the Federal Government can no longer afford to continue to heavily subsidize electric and telephone borrowers, many of whom serve urban and suburban areas.

For these reasons the Administration opposes these additional unnecessary subsidies to REA borrowers, and I ask your help in this matter. I will be pleased to provide additional information.

Please let me know whenever we may be of assistance.

Sincerely yours,

James C. Miller III
Director

The CHAIRMAN. Do you have any understanding, or have you had any communication, about whether the President would veto a provision passed by Congress to allow REA's to pay off those loans?

Mr. SETHNESS. Were it free-standing, no question about it.

The CHAIRMAN. You think he would if it were free-standing, but not if it were in the CR or something like that?

Mr. SETHNESS. Speculating on what the President would do with respect to the package is dangerous territory.

The CHAIRMAN. Can you make the distinction for me between allowing REA borrowers and small business borrowers to pay these loans off? Can you make the distinction between that and the President's proposal to sell the 503 loan portfolio at about 50 cents on the dollar and other asset sale proposals?

Is there not a contradiction in the Administrations support for asset sales and their objection to this Bill? I think these asset sales are outrageous. I oppose almost every one of them because many of those portfolios are tremendous, and many of them are durable, long-lasting assets.

And to sell them in order to do something with the budget, that one-shot deal—you always ask, what do you do for an encore?

It is my opinion that those assets will not bring anything like what they really are worth, due to the magnitude of the sale and due to the fact that their value, some of their value, is going to go up.

Can you make a distinction between those two or not?

Mr. SETHNESS. Between hard asset sales and this?

The CHAIRMAN. Yes.

Mr. SETHNESS. They are completely different in kind. One of them is the sale of a hard asset, the other is allowing somebody to do something that he could anyway cheaper than his contract says he ought to be able to do.

Senator METZENBAUM. Has the Administration given notice to their Republican colleagues about their position on that, the rural electrification? Because I have not heard any voice of protest from anybody in Congress on the Republican side.

Mr. SETHNESS. We certainly have been communicating it rather clearly. As I am sure you are aware, there was a fairly strenuous fight last year over allowing prepayments.

Senator METZENBAUM. Yes, I led it. But I do not remember any particular support from the Administration in helping to get votes. I remember it very well.

Mr. SETHNESS. I was doing the best I could, sir.

The CHAIRMAN. Let me just say for the record, and this is in my opening statement which I inserted in the record, we have asked CBO, Senator Metzenbaum, for a cost estimate on this Bill. But we have not received it yet. We will distribute that information when we get it.

I know that—I am sure that OMB's figures would vary from CBO's, so we have not asked them. And they are violently opposed to it and we do not trust their figures anyway.

Senator METZENBAUM. I might say to you, Mr. Chairman, that such costs as there might be would be in the out years. The presently pending budget matter contemplates passage of this legislation.

The actual cost, there would be income to the Government if the prepayments were lowered, because there would be a reality that is not a fact at the present time.

The CHAIRMAN. Senator Metzenbaum, I believe there are about 1,600 of these loans outstanding.

Senator METZENBAUM. He says it is 4,000, Mr. Chairman.

Mr. SETHNESS. There are about 4,600 outstanding. 1,600 would be those loans at the higher interest rates.

The CHAIRMAN. And probably subject to the benefits of this bill.

Mr. SETHNESS. Yes.

The CHAIRMAN. Now, that is the number I wanted. And what I really wanted to know is, Senator Metzenbaum, of those 1,600 borrowers who would benefit from this prepayment, do you have any idea how many would be eligible or financially viable enough to get private financing in order to pay this off?

Senator METZENBAUM. I am only giving you a standing-on-one-foot answer. My guess is maybe a third, maybe 25 percent, because some of them are still struggling small business operations that could not have gotten a loan in the first instance, and I do not think they could get a loan from a commercial lender in the second instance.

The amounts involved become smaller and smaller when we recognize that the losses are lost well into the future, only about one-fourth of the 1,600 that might prepay. So we are talking about a very modest amount of money from the Government's standpoint, but a very important amount of dollars from a small businessman's standpoint.

The CHAIRMAN. Senator Metzenbaum, your bill does not seem to address anything except the penalty provisions between the borrower and the Treasury. My concern is that the CDCs' contracts with the Treasury also have a penalty provision in them, and the CDC's say they will be devastated by this unless they are included, because, as I understand it, and I stand to be corrected, you are going to allow the borrower to pay off the CDC and the CDC in turn is going to have to pay FFB.

And they are going to have to have some relief, too, are they not?

Senator METZENBAUM. Well, if there is some relief necessary for them—and I am not exactly certain of the mechanics and how that would work, but my guess is that if the CDC needs relief, we are talking about minimal amounts of money, not significant amounts of money, because they are not the prime lender.

The CHAIRMAN. They are also operating on about a one-eighth service fee. And of course, they are concerned about losing that. Is that about what they operate on? One eighth of a point.

And would you have any objection to your bill also taking care of whatever adverse effects—I'm not sure precisely what they are—whatever adverse effects it might have on the CDC's?

Senator METZENBAUM. No, I would not have any objection to working out something that is reasonable, although I would say that, since they would not have to be doing the servicing, I do not think they would be entitled to the same amount of the one-eighth.

But I think we are getting down into such small numbers that, as the author of the legislation, I am certainly willing to negotiate something that is fair and reasonable.

The CHAIRMAN. What you would do is eliminate the penalties from the Treasury Department on down, is that right?

Senator METZENBAUM. That is correct. And I want to try to help small business people, who I think—I just think that, of all the people in the Country who ought not to get penalized in a matter like this, it is they.

The CHAIRMAN. The Treasury Department argues that if we do this, they make the argument here, but it could be made on this plus the REA discounts, that if Congress passes your bill and also allows REA's to prepay their loans, which they desperately want to do, all Government borrowers are going to descend on Congress to ask for the same kind of relief.

Do you consider that a valid argument?

Senator METZENBAUM. I do not consider it a valid argument.

The CHAIRMAN. Why not?

Senator METZENBAUM. Well, first of all, I think if they had such thoughts they already would have been coming forward and asking to be added into the bill. I have not heard a word to that effect. None of them have come forward making that suggestion.

And I do not think that that is a problem. I think that is just a smokescreen. If somebody else wants to be given the same consideration, I think it is appropriate that we consider it on its merits. But at this moment, this bill has been pending for several months and I have not heard any words to that effect at all.

I think it is just a figment of somebody's imagination.

The CHAIRMAN. Do you have any objection to the proposal on the REA?

Senator METZENBAUM. I have had some difficulties with it. The last time it was up, I raised questions about it even coming to the Floor. And the answer is yes, I do have some difficulties with it.

The CHAIRMAN. Can you make a distinction between that and your bill?

Senator METZENBAUM. Well, it is difficult to make a distinction.

The CHAIRMAN. Other than just amounts? The amounts are much bigger.

Senator METZENBAUM. Amounts are far, far bigger. And the point that the REA proposal effects literally thousands, maybe hundreds of thousands of farmers, rural persons, the one thing good about that, the one argument you can make, is, well, these are not business people, these are people who are buying electricity for their homes, although also for businesses as well, and that we are just trying to—we set up the cooperative movement in the first instance and recognized the rural electric cooperatives because we thought it would be a way of extending power to the hinterlands of the Country.

Now, I think that they come in and they are asking for prepayment rights. Some groups that are asking for prepayments are very, very, very substantial agricultural cooperatives. They are no longer small farmer operations. They are big business in the ultimate sense of the word.

I would be much more comfortable if we could, in that legislation, distinguish between those co-ops that provide service exclusively for small users, the family farmer, the individual, and deduct or in some way get an allowance so that they not provide the same advantage to the large industrial and agricultural co-ops that exist in this Country.

The CHAIRMAN. Of course, that is their argument, that the farmers and the rural people will receive the benefits of that type of allowance.

Senator Metzenbaum, I am generally favorably disposed toward this bill. I am a little bit troubled about the fact that any time things go in favor of the borrower and against the Government, we always have a tendency to give them a break, and if it goes the other way we do not.

Senator METZENBAUM. You are right.

The CHAIRMAN. And I am just wondering if you find any middle ground here, so that at least the Treasury is sort of made whole. In other words, the Treasury says these prepayments are going to cost $147 million, I believe. We will wait and see what CBO says about it.

But in any event, is it fair to just give this big windfall to either REA or the small business borrowers?

Senator METZENBAUM. I would say to the Chairman, in the legislative process—and he knows this every bit as well as I do—there often is not a right and a wrong answer. There often is a compromise position, a negotiated position. And I did not gain the title of being reasonable Howard for nothing.

I would be very reasonable, Mr. Chairman, and certainly would try to work with the Administration if they too want to be reasonable on the subject.

The CHAIRMAN. Senator Metzenbaum, thank you very much for your testimony. We appreciate having you.

Oh, I am sorry, Senator Metzenbaum. Senator Pressler.

Senator PRESSLER. He has got to be subjected to some Republican questions.

Senator METZENBAUM. Peaceable Larry, go ahead with your questions.

Senator PRESSLER. You are as vigorous on the witness stand as you are on the tennis court.

Mr. Metzenbaum, I may become a co-sponsor of your Bill. I would like to see an amendment to address in some way the CDC problem. South Dakota's CDC's, are extremely small and depend heavily upon the income they receive through the servicing of these loans.

It sounds strange that when people want to prepay something the U.S. Government does not want to take the money. But as I understand, the CDC's depend on the small amount of servicing fees they take in. Only by collecting these fees on existing loans are they able to pay their staff and other expenses.

In other words, only through these fees are they able to stay in business.

Is there some way that you would accept an amendment to your bill that would take care of some of these small CDC's?

Senator METZENBAUM. I do not think we would have any trouble in figuring out some way to handle that. I do think that the CDC's have to recognize that their money goes back to the SBA. They are able to

use that money to lend out again. So it is only fair to say that they may get the money back from Sioux City, IA, and they may lend it out in Sioux Falls, SD.

And so it is hard to say for certain. But I am not opposed to that. I think we could work out something.

Senator PRESSLER. I wonder if you would be amendable to an amendment that would say that if CDC's of a certain small size, or any size, should experience prepayment problems they would be somehow given whatever fee they would have collected, perhaps this would not work because then the SBA might loan it out again and we might be enriching the CDC's.

But there could be some kind of a partial formula.

Senator METZENBAUM. I think we could give them a commuted partial value of what they would have received. In other words, let us assume they are getting a half a point. Maybe you take the figure—and I am just picking this out of my head—a quarter of a point, and then you figure out what the commuted value of that is, since that would have been paid out over a period of 10 years.

And then you say to the borrower, in order to prepay you have to make this adjustment to that extent. I do not think it would be that much money.

Senator PRESSLER. I have asked my staff to prepare such an amendment. I would like the privilege of offering the amendment on the Floor. With your potential support to such an amendment, I would like to be added as a co-sponsor.

Senator METZENBAUM. We are very happy to have you as a co-sponsor of the bill, Senator Pressler.

Senator PRESSLER. Thank you.

[The prepared statements of Senators Pressler and Weicker follow:]

STATEMENT BY SENATOR LARRY PRESSLER
BEFORE THE
SENATE SMALL BUSINESS COMMITTEE
HEARINGS ON S. 437
JUNE 18, 1987

I would like to begin by thanking the Chairman for calling this hearing. I think we would all agree that the Small Business Administration's Section 503 Certified Development Company (CDC) program is one of the most successful loan programs in the Administration's history.

In my home state of South Dakota, many businesses have benefited from this "bricks and mortar" program. Historically, capital for small business expansion and the job creation which results from such expansion has been tough to come by. Reductions in EDA and UDAG funds, limitations on tax-exempt financing and the severe credit crunch experienced in the agricultural economy over the past several years have combined to exacerbate the difficulties faced by small businesses seeking expansion capital. The 503 program has worked very well in bridging this credit gap.

Now, many of the same businesses which benefited so greatly from 503 loans are faced with a new problem. These businesses have grown. Many have become much more financially sound as a result of their expansion. Like other businesses, as the result of falling interest rates they are reviewing their loan packages with an eye toward refinancing at lower rates. Under the rules of the 503 program, this is often impractical and, many times, virtually impossible.

For this reason, I believe the spirit of S. 437 is laudable. However, I have concerns which I hope can be addressed during today's hearing. After discussing this concept with the Director of one of South Dakota's CDCs, I am uneasy about what this bill, as it now stands, would do to the operating capital of many of our CDCs. This is especially true in my state where the CDCs tend to be quite small and operate on extremely tight budgets.

These CDCs depend on the small amount of servicing fees they take in. Only by collecting these fees on existing loans are they able to pay their staff and other expenses. In other words, only through these fees are they able to stay in business and extend 503 and 504 loans to other small businesses. This issue must be addressed or we risk throwing the baby out with the bath water.

In addition, if I understand the legislation correctly, small businesses that decide to prepay their 503 loans would then be required to refinance through traditional financing sources. If this interpretation is correct, it would seem a bit inconsistent with the reasoning upon which the 503 program was built. Section 503 was created for those businesses having difficulty securing capital from conventional sources. Should we now say to these businesses that they can refinance only if they have become strong enough to secure a more traditional loan? Should we force those businesses which cannot obtain such financing to remain locked in at their current higher-than-market interest rates?

Finally, I will be very interested in hearing the points of view of the SBA and the Department of Treasury. Like most things our government does to provide assistance to the citizens of this

country, this proposal will cost money. If a small business prepays or refinances at a lower rate of interest, the federal government will lose revenue. The SBA currently must pay the same premium borrowers incur if it is called upon to honor its guarantee in the event of a default.

Under S. 437, the SBA would be given the same favorable prepayment terms and, thus, would save money. However, with a default rate of around 3 percent, it is unlikely that the amount of federal revenues expended each year to honor guarantees will even come close to the amount of revenue lost to prepayment agreements.

As I mentioned at the outset, I agree with what S. 437 tries to accomplish. I hope that the issues I have raised can be addressed during today's hearing and that an equitable solution which balances the needs of the small business community and the CDCs, but which does not significantly add to the national debt, can be developed.

I would like to thank the witnesses for taking the time to testify here today. I look forward to hearing their views.

Opening Statement of
Senator Lowell Weicker, Jr.
on
S. 437, to Amend the Small Business Investment Act

Mr. Chairman, I commend you for holding this hearing on S. 437 a bill introduced by my good friend Senator Metzenbaum. The bill seeks to address a tough problem for small business owners who have financed their expansion projects through the use of the Small Business Administration (SBA) Section 503 Certified Development Company program. The prepayment penalty required by the Federal Financing Bank (FFB) has been a real problem for small businesses that have received loans under the program, and is probably one of the most troubling problems for the SBA economic development program. Indeed, small businesses from my home state of Connecticut, like others around the country, have been shocked when they fully realized the amount of the premium they would be required to pay in order to prepay their 503 loans.

When we established the section 503 Certified Development Company program in 1980, we did so to make long-term reasonably priced fixed-rate financing available to expanding small businesses to create jobs. We also sought to encourage private sector banks to participate in making fixed asset financing available to small businesses. The program has worked well. Approximately 600 CDCs nationwide have been certified by SBA and the program has become an important tool for local economic development. Since the inception of this program SBA has approved over 6700 loans totaling more than $1.3 billion, creating or retaining over 160,000 jobs. By these measures the program has been very successful.

During the period of high interest rates in the early part of this decade, the program was very effective in providing affordable financing for small businesses. Now that interest rates have come down the prepayment penalty required by the FFB is a major obstacle to small businesses that can refinance their loans at lower rates. We will hear more later today on how the FFB premium impacts small businesses.

Also, we will hear from a representative of certified development companies that provide the important link for delivering the services of this vital economic development program to the small business community. As Mr. David Main, representing the National Association of Development Companies will testify, the Committee should also consider the impact of the bill, as presently drafted, on the network of CDCs that rely on the program.

Finally, of course, we must consider the cost of this legislation to the U.S. Taxpayer.

Mr. Chairman, I look forward to hearing and reviewing the testimony that we will receive today on this important issue and working with you in the future on ways to address this problem.

The CHAIRMAN. Senator Weicker, do you have any questions?

Senator WEICKER. No questions.

The CHAIRMAN. Senator Metzenbaum, thank you very much for coming.

Senator METZENBAUM. Thank you very much.

The CHAIRMAN. Our next panel is Mr. Bruce L. Bartlett, president of Roberge Sheet Metal, Inc., Seattle, WA, and Mr. Don T. Compton, president, Whitewater Industries in Harrison, OH.

Mr. Bartlett, you were first up, so please proceed. Feel free to summarize your testimony and your full statement will be inserted in the record.

STATEMENT OF BRUCE L. BARTLETT, PRESIDENT, ROBERGE SHEET METAL, INC., SEATTLE, WA

Mr. BARTLETT. It is a pleasure to testify today before the Committee on Small Business on behalf of my company and on behalf of other small businesses affected by this problem.

I am also here today as a private citizen and as a businessman. I am President of Roberge Sheet Metal, Inc., of Seattle, WA, a company that is involved in metal fabricating and manufacturing and is a borrower under the 503 loan program.

I have also been a past delegate to the White House Conference on Small Business. I serve on numerous small business organizations in terms of their boards and in terms of the Governor of the State of Washington appointing me to serve on the Small Business Improvement Council of Washington.

I am also a national board member for the Sheet Metal and Air Conditioning Contractors National Association.

I am encouraged that the Committee is holding hearings. I am concerned about the problems that are presented by the prepayment provision, and I have prepared testimony that I have submitted in writing and, rather than read all of it, I would like to summarize such and then get into some other points that I may not have covered in my written testimony.

Basically, the written testimony provides a briefing to the Committee as to how I have learned to define the yield or the reason for the prepayment penalty as it exists now. The FFB is concerned and has set policy, either through the Department of Treasury or through their own division or department, to achieve an even yield to remain revenue neutral.

I have defined "even yield" in my written testimony to simply say that, if you prepay the loan, FFB would also like you to pay what it would have yielded for the life of the loan.

I would concur with the testimony by Treasury earlier or FFB in the sense that if interest rates were lower there would be a discount, or if such were higher, and the market was lower, it would just be the difference between what FFB could do with the money, in terms of reinvestment, after you repaid a 503 loan.

It would not necessarily be for the entire yield. It would be a factor for what they could in fact reloan or reinvest it for. If they could reinvest it for 10 and you had borrowed it for 15, then it would be that difference.

I've also defined "private sector" in my written testimony. There are prepayment penalties in the private sector, but they are not as severe or as rigid. They tend to be declining over a period of time of the loan.

I have a first mortgage loan on my property that is a conventional loan, and it has a 3 percent prepayment penalty, and it declines down to about a quarter of a point over approximately a 5 to 10 year period, and then it disappears.

I have also indicated in my written testimony——

The CHAIRMAN. Is that your home you're talking about?

Mr. BARTLETT. No, sir, that's the property that also has the 503 loan.

The CHAIRMAN. That is the real estate?

Mr. BARTLETT. Yes.

The 504 program is interesting to me in that it has a prepayment penalty that declines either over a 5 or 10 year period, depending on the length of the debenture. Those interest rates, in my opinion, are high. I should say those prepayment penalties.

They're high for a reason. There is risk taken, risk that may be considered, and I think justly so, on a higher scale than on a conventional loan that you would realize through a savings and loan or mortgage banking institution.

They are not, however, as high as the prepayment penalties of the 503 loan as it exists now. I have indicated in my testimony that times have changed, that inflation is no longer at a double digit level. When I first wrote to Congressman Chandler, who is a good friend of mine, I described the inflation level at 2 to 3 percent, and in my testimony to the Committee I've revised it to 4 to 6 percent. Basically, that is lower than double digit.

I define the prime interest rate in my first letter to Congressman Chandler as I think seven and a half and now it's eight and a quarter. This is still a low interest rate.

Mortgage rates, I think I indicated at one time were 8 to 9 percent, and now they're more like 9 to 11 percent. This is still down.

What's interesting is to look at what business has to deal with. I'm a metal fabricator and a manufacturer. I purchase steel, I purchase stainless steel, I purchase a lot of raw materials. Steel companies up until just recently were selling at 1979 prices to be competitive, to remain in the marketplace.

I found that if I did not keep my prices competitive, if I did not deal with my labor unions or with my suppliers or with my lending institutions in terms of the costs I pay or the base labor rates I pay, that I would have little, if any, control over the cost of sales or my overhead charges, and would remain less than competitive in the marketplaces that Roberge Sheet Metal functions within.

I have had to make adjustments. In my opinion, it's the way that business works. And I found that when I had loans that were higher—the rate, of course, floated—if I had fixed loans that were higher, then I would refinance such, when lower levels become available. Sometimes I have had to pay a penalty for that or a fee, but it has not been a fee or a penalty as high as the 503 repayment provision stipulates.

In my written testimony I attempted to give the Committee some background as to other businesses that have come to me in the Se-

attle metropolitan area regarding the 503 prepayment problem. You mentioned one that you read into the record, World Tire. That's in Tukwila, WA.

The owner has met with me by phone. He has talked with Congress. He is frustrated. He wishes to sell his building because he has a number of operations and numerous locations throughout the Seattle metropolitan area, and at times business may be down in one area and up in another, and he wishes to change the nature of his operation.

He had invested and owned the property that the building is built on. He spent about $200,000 of his own money. That's his equity in the real estate. If he were to pay off his loan today, it would cost him approximately $195,200 dollars in prepayment penalties. He would lose his equity.

He has been reluctant to do that. He is also a businessman and knows that to continue operations in a location that is not surviving does not make sense.

So he has put the property up for sale and he has set the selling price at higher than market value, to encompass or include this prepayment penalty. He may never sell the property at this level.

An owner of a restaurant has come to me and talked about his particular loan. His balance is about $200,000, and I stipulated that in my written testimony. His prepayment penalty is $125,000. He has been offered a commitment at 9.5 percent for a conventional real estate loan. He is currently paying 15.5 percent under the 503 loan program.

Here is a business that would be able to obtain a conventional loan. They—conventional savings and loan—are unwilling to lend the money until this is resolved. He is finding it difficult to operate and could use the capital to not only continue renovations on the building or refurbishing, but also for operations.

In the case of Roberge, I am not here to say that I would like to pay my loan off. I am an unusual case. I continue to pay on the loan at the current interest rate of 13.9 percent. I have no desire to pay it off today. I do not have a desire to see the CDCs devastated by a run on the market or a run on the bank, if I could put it in those terms.

At the same time, there is no one case that can say that it applies to everyone here in terms of, let's have no prepayment penalty or let's have it be a situation where we just say, okay, all of you 503 loan recipients, pay your loans off without a prepayment penalty.

There are many cases, and it's a complex situation. And for that reason, my testimony, the part that I would like to read—and I have some additional testimony I would like to enter into the record that I did not send prior to my arrival here today—and by the way, I am here today as a concerned businessman. The cost of this trip and the time I've spent on this issue is on my nickel, and I'm concerned for small businesses and for the direction that this economy is taking. I support the Administration's direction for the most part, but I'm concerned enough that there be changes. I have recommended some additional ones.

In response to all of these situations, I urge the passage of S. 437, and request that additional changes be considered.

One, allow 503 loans to be privately refinanced, subject to prepayment penalties currently in effect under the existing 504 loan program, or subject to fees to cover the administrative costs for processing early payments.

The CHAIRMAN. Let me just stop you at that point. If you refinance in the private sector, how can Congress dictate what the penalty is going to be?

Mr. BARTLETT. What I am suggesting is that the 503 borrower may want to pay his loan off and go out into the conventional marketplace. That is what I am saying. He may want to privately refinance his loan, and he has to pay it off to do that. In other words, he has got to pay it off, and I am suggesting that it be subject to one of two things.

The CHAIRMAN. Oh, that particular kind.

Mr. BARTLETT. Yes, sir. Prepayment penalties that are currently under 504 are subject to some fee to cover administrative costs for processing the early payments, or for impacting the system, CDC level, FFB level, and so forth.

Number two, I am suggesting that, and this may seem strange, but it was due some consideration, and that was to allow small businesses with 503 loans which have interest rates equal or less than, let us say, 8.5 to 9.5 percent, the range that the debentures are selling in right now. A 1 year grace period to pay off such loans and realize a discount, or become subject to the same prepayment penalties that are under 504 or whatever is set up. Now that may be totally unfair, it may not be possible to do. I am attempting to keep the playing field as even and level as I can in my testimony.

Number three, allow 503 loans to be refinanced under the 504 loan program at their current mortgage balance levels, with an assessed loan fee, comparable to such charges assessed by conventional mortgage sources—examples I have used are 1 to 2 percent—in lieu of the prepayment penalty currently in effect under the 503 or 504 loan program, in other words a one-time situation.

And I might stop here and say that, I appreciate Congressman Chandler's efforts and I hope to have Senator Evans and Senator Adams from the State of Washington involved in this by this afternoon. And I am planning to meet with the Department of Treasury this afternoon, and the House, and make this a useful day to be in Washington, DC.

But I do think, and I might depart for a minute and I am not getting off the subject, but I do think that what is happening here is that there is confusion. Congressman Chandler has written letters to the Department of the Treasury—Secretary Baker. He has written letters to Congressman LaFalce, who is the chairman of the House Small Business Committee. He has written letters to the State of Washington Senators. And in those letters he says that he is very much in support of S. 437.

But he has also indicated that he certainly thinks that the provision in the legislation for the rollover of 503s into 504s is worthy. That is not in the legislation. I am not convinced that Secretary Baker of the Department of the Treasury, members of the President's administration that work in the White House, and for that matter necessarily Members of the House of Representatives or

people who have not been close to this issue really understand the issue.

The legislation only says, in terms of S. 437 to eliminate the prepayment penalty, to change that provision. But there are other considerations that I think others would like to see. For that reason, they have been acting like it is in that legislation. That is the one time allowance or opportunity for 503 recipients, or borrowers, to be able to renew those loans under 504 and be subject to new prepayment penalties, which are declining.

There may have to be a fee that is paid. In the case of the ramifications or parameters associated with that, I indicate here in number four, to require that small businesses under the 503 program who wish to refinance under 504 mortgage terms and conditions, meet all eligible requirements for such loans. It would not just be a mandated wholesale situation.

Now, number five is the bottom line to allowing that, and that is an increase to the budget authority of the SBA 504 loan program, would be necessary in order to include the refinanced 503 loans without jeopardizing or otherwise impeding the availability of such loans, and I am talking new 504 loans, to small businesses.

It has been estimated, and I am not sure my estimates are exactly correct, but of a half billion dollars, or $500 million of loans out there, approximately 25 percent or thereabouts would be affected by this. That would result in another $125 million needing to be added to the legislation that continues the 504 program, in order to make this happen.

These additional recommended changes would enable S. 437 to fully address the complex requirements of small business, maintain a sound and businesslike approach to partially preserving the revenue neutral position, I said partially I did not say completely, of the Federal Finance Bank and would, in my opinion, bring the Federal Government's mortgage loan practices in line with related mortgage loans implemented under the Rural Electrification Administration, and Fannie Mae and Ginnie Mae loan programs.

I believe, Mr. Chairman and Members of the Committee, that the Small Business Investment Act of 1958 has been both positive and constructive in terms of assisting small business. It is not the intention of the Act to assess inordinate prepayment penalties. I do not think that was the intention. Therefore, this legislation should clearly mandate to the Department of the Treasury and the Federal Finance Bank changes that are more equitable and comparable to the current business climate.

The reason I suggest this is that I fully intended to come to this Committee hearing today, 1 or 2 months ago, and recommend that the legislation be changed to address the rollover of 503s into 504s which have a declining prepayment penalty, because as I understand it, it is a policy of the Federal Finance Bank, or for that matter the Department of the Treasury, to charge what they are charging.

It is not necessarily a part of the legislation that they work under. Granted, it may say that they need to remain revenue neutral. That is open to interpretation. But because I have understood that there is a reluctance on the part or parts of the administration—I seriously doubt that all parts of the administration are

aware of this—then I strongly would recommend that not only this legislation pass, but it be expanded to deal with a number of issues, not just the elimination of prepayment penalties. That it clearly instruct the Department of Treasury, or for that matter the Federal Finance Bank, what the guidelines shall be, and not leave it to them to promulgate. There is some concern that those guidelines may be misinterpreted, or for that matter misunderstood, or viewed as the prepayment penalty situation is viewed today.

I wish I could operate my company this way. I wish I could take a job in my company and say I want that job to produce this type of return, I want every job that I do to produce that same return. I want very much to achieve this type of deal. And I want to control all the conditions and keep it in its pristine state. That is not realistic. Neither is mortgage lending with high prepayment penalties.

I would end my remarks by saying that I have additional testimony I would like to leave with the Committee today. I have basically summarized other views from borrowers that I have discussed this concept or this problem with, which are as follows:

From the point of view of most borrowers under the 503 program: a, A 503 loan is strictly viewed as a loan transaction and not a marketable security; b, the program's intent is to assist small businesses through the availability of non-standard loans designed not to hinder flexibility, and the third part of number one is for the most part bonds and/or debentures have varying degrees of market risk which cannot be avoided. That is one viewpoint of a general manager in a company that has reviewed these policies in detail, read letters of response from Congressman Chandler from the Treasury that parallel the testimony of Treasury today.

Number two, a higher prepayment percentage as delineated in the 504 loan program schedule should be sufficient compensation for market risk. And I will be entering in the record today that schedule of prepayment penalties that is currently in effect under 504.

Number three, a borrower under the 503 and 504 programs would not receive a subsidy by the Federal Government if he pays the full principal and accrued interest, and a reasonable prepayment penalty prior to the maturity date of said loans.

Number four, the economic theory, or let us say, principle, of the discounted present value of money is not taken into consideration by the Federal Finance Bank relative to prepayment of 503 loans.

The Federal Government, and this is number five, does not require Fannie Mae or Ginnie Mae borrowers to pay more than the oustanding principal balance, accrued interest to date, and a reasonable prepayment penalty. Granted, these loans may not be commercially oriented, but that same situation exists, in my opinion, and in the opinion of mortgage lenders in the conventional or private enterprise area.

Number six, the even yield policy is usurious, as such relates to the prepayment penalty currently in effect under the 503 program. It goes beyond what is reasonable in an interest rate or in terms of fees or charges.

Thank you for the opportunity to testify before the Committee and I will answer any questions.

[The prepared statement of Mr. Bartlett follows:]

Roberge

Roberge Sheet Metal, Inc.
3411 First Ave. South, Seattle, WA 98134
Phone (206) 622-8384

June 15, 1987

TO: United States Senate
Committee on Small Business
Washington, D.C.

FROM: Bruce L. Bartlett
President
Roberge Sheet Metal, Inc.
Seattle, WA

SUBJECT: S.437 - A bill proposing to amend the Small Business Investment Act of 1958 to permit prepayment of loans made to State and local development companies...

It is my pleasure to testify today before the Committee on Small Business of the United States Senate on behalf of Roberge Sheet Metal, Inc., a small business which has an existing 503 SBA loan, and on behalf of small businesses in general affected by the prepayment provisions of the program. I am also pleased to be here today as a private citizen and businessman.

My name is Bruce Bartlett and I am the President of Roberge Sheet Metal, Inc., a metal fabricator and manufacturing company in Seattle, WA, and a past delegate to the 1986 White House Conference on Small Business, member of various small business organizations and the Sheet Metal and Air Conditioning Contractors Association (SMACNA).

I am encouraged that the Committee on Small Business has chosen to conduct hearings on Senate Bill 437, a bill which proposes to amend Section 503A of the Small Business Investment Act of 1958, concerning the prepayment of loans made from the proceeds of a debenture guaranteed under the aforesaid Section. In my opinion, the more information provided with regard to the prepayment penalties associated with 503 loans and their affect on small businesses, will result in a higher awareness and better understanding of the changes required to assist both the federal government and private enterprise in remaining operationally effective and/or competitive.

I strongly support the changes proposed in Senate Bill 437 and respectively offer the following justification for my support which includes additional recommended changes to the Small Business Investment Act of 1958, as such relates to the prepayment of 503 loans:

The Federal Finance Bank of the Dept. of the Treasury has established a policy for achieving an "even yield" on all 503 loans. "Even yield" is defined as achieving an equal return on all 503 loans pursuant to the terms and conditions of a debenture sold for a ten or twenty year term. If loans are paid by small businesses prior to their maturity dates, such businesses are assessed a prepayment penalty which requires a given borrower to pay, in addition to the unpaid principal balance and accrued interest, an amount equal to what the loan would have yielded over a ten or twenty year period.

The Small Business Administration and State and local development companies have been required to pay the same prepayment penalties, when liquidating loans provided small businesses. Such public and private entities have been assessed a prepayment penalty after paying off the entire principal balance and accrued interest. It is my understanding, with regard to the Small Business Administration (SBA), that the Federal Finance Bank of the Dept. of the Treasury has continued to bill the SBA monthly, the difference between the balance paid and the projected yield of the loan.

Most mortgage lending institutions, public or private, have set prepayment penalties which are established on a declining basis over the life of a given mortgage loan and usually disappear after a certain number of years, prior to the end of the term of such loans. In the case of the 503 mortgage loan program, the existing prepayment penalty is severe, far too rigid, and economically hinders both small businesses, as well as various agencies of the federal government.

The current SBA second mortgage loan program (i.e.,504) has a declining prepayment penalty schedule and has eliminated the penalty after five or ten years. This particular prepayment schedule is not however applicable to the 503 program. The present interest rate for the 504 program is approximately nine to nine and one half percent while most 503 loans implemented in 1981 to 1983 are at a thirteen to fifteen and one half percent rate of interest.

Roberge Sheet Metal, Inc. has an existing SBA 503 loan with an interest rate at thirteen and nine tenths percent (13.9%) and is subject to the prepayment penalties previously described under the "even yield" scenario. There is a possibility for Roberge to repay early the 503 loan and not realize prepayment penalties if, and only if, the Federal Finance Bank of the Dept. of the Treasury is able to reinvest the mortgage loan funds at the same or a higher interest rate. This possibility is not realistic or achievable at this time.

Given the times, inflation at four to six percent, a prime interest rate of eight and one fourth percent, mortgage loan rates of nine to eleven percent, a willingness by labor unions to change work rules favorably and request no or minimal increases to base rates, the competitiveness of business, conducted in this country, has reached a level where cost of goods sold and overhead charges must remain equal to, if not less than, previous years. The competitive and entrepreneurial environment of small business can only remain effective through the implementation of opportunities to lower interest and other costs directly tied to operational overhead.

Other small businesses within the Seattle metropolitan area, affected by the prepayment penalty of the 503 loan program, have been unable to pay off and refinance conventionally, their 503 SBA second mortgage loans, or for that matter, sell their property for economically justifiable reasons. Specifically, Duke's Restaurant in Seattle, WA, which has a $210,000, 503 SBA loan at an interest rate of fifteen and one half percent, has been informed that a prepayment penalty of an additional $125,000 would be required relative to paying off the 503 loan, and replacing such with a conventional mortgage loan at a nine and one half percent interest rate. The owner of Duke's Restaurant has also been unsuccessful in selling the property, as a result of the existing prepayment penalty provisions.

Concurrently, an owner of a tire store in Seattle has expressed interest in selling a building which houses one of his many operations. The property is financed in part by a 503 loan subject to the existing prepayment penalty requiring an "even yield". Based on a reduction in business sales and for personal reasons, this owner is interested in selling the property. His prepayment penalty would result in an additional $200,000 having to be paid to the Federal Finance Bank, an amount equal to his equity investment. In this case, the owner has set the sale price to encompass this prepayment penalty and as a result, finds himself having to sell the real estate above fair market value.

In response to these situations, I strongly urge the passage of Senate Bill 437 and respectively recommend additional changes:

1. Allow 503 SBA loans to be privately refinanced, subject to prepayment penalties currently in effect under the existing 504 loan program and/ or subject to fees to cover the administrative costs for processing the early payments...

2. Allow small businesses with 503 loans, which have interest rates equal to or less than eight and one half to nine and one half percent, a one year grace period to pay off such loans and realize a discount or become subject to the prepayment penalty schedule currently in effect under the 504 loan program at the end of the grace period...

3. Allow 503 loans to be refinanced under the 504 loan program at their current mortgage balance levels with an assessed loan fee comparable to such charges assessed by conventional mortgage sources (e.g., one to two percent), in lieu of the prepayment penalty currently in effect under the 503 or 504 loan programs...

4. Require that small businesses under the 503 program, who wish to refinance under the 504 mortgage terms and conditions, meet all eligibility requirements for such loans...

5. Increase the budget authority of the SBA 504 loan program in order to include the refinanced 503 loans without jeopardizing, or otherwise impeding the availability of such loans to new small business borrowers (NOTE: The recommended increase would involve approximately $125,000,000)...

These additional recommended changes would enable Senate Bill 437 to fully address the complex requirements of small business, maintain a sound and business-like approach to partially preserving the "revenue neutral" position of the Federal Finance Bank and would, in my opinion, bring the federal government's mortgage loan practices into line with related mortgage loans implemented under the Rural Electrification Administration and Fannie Mae and Ginnie Mae loan programs.

I believe, Mr. Chairman and Members of the Committee, that the Small Business Investment Act of 1958 has been both positive and constructive in terms of assisting small business and it is not the intention of the Act to assess inordinate prepayment penalties. Therefore, this legislation should clearly mandate to the Dept. of the Treasury and the Federal Finance Bank, changes that are more equitable and comparable to the current business climate.

Thank you.

Bruce L. Bartlett

BLB/mh

Roberge Sheet Metal, Inc.
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June 15, 1987

Additional Testimony Re: S.437-a bill proposing to amend the Small Business Investment Act of 1958 to permit prepayment of loans made to State and local development companies....(Refer to attached.)

1. From the point of view of most borrowers under the 503 program:

   a. A 503 loan is strictly viewed as a loan transaction and not a marketable security...

   b. The program's intent is to assist small businesses through the availability of non-standard loans designed not to hinder flexibility...

   c. For the most part, bonds and/or debentures have various degrees of market risk which cannot be avoided...

2. A higher prepayment percentage as delineated on the attached 504 loan program schedule should be sufficient compensation for market risk...

3. A borrower under the 503 and 504 programs would not receive a subsidy by the federal government if he pays the full principal and accrued interest and a reasonable prepayment penalty prior to the maturity date of said loans...

4. The economic theory of the discounted present value of money is not taken into consideration by the Federal Finance Bank relative to prepayment of 503 loans...

5. The federal government does not require Fannie Mae or Ginnie Mae borrowers to pay more than the outstanding principal balance, accrued interest (to date) and a reasonable prepayment penalty...

6. The "even yield" policy is usurious, as such relates to the prepayment penalty currently in effect under the 503 program...

Respectfully submitted,

Bruce L. Bartlett

GEN. CONTR. REG. NO. 223 01 RO BE RS M247 JN

II

100TH CONGRESS
1ST SESSION

S. 437

To amend the Small Business Investment Act of 1958 to permit prepayment of loans made to State and local development companies.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 3, 1987

Mr. METZENBAUM introduced the following bill; which was read twice and referred to the Committee on Small Business

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A BILL

To amend the Small Business Investment Act of 1958 to permit prepayment of loans made to State and local development companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Small Business Investment Act of 1958 is amended by inserting after section 503 (15 U.S.C. 697) the following new section:

"PREPAYMENT OF LOANS

"SEC. 503A. (a) A borrower of a loan made from the proceeds of a debenture guaranteed under section 503 of this Act may prepay that portion of such loan or any loan advance thereunder by paying the outstanding principal balance

due on that portion of the loan or advance (plus any accrued interest).

"(b) No sums in addition to the outstanding principal balance (plus any accrued interest) due on the portion of a loan made from the proceeds of a debenture guaranteed under section 503 may be charged as the result of such prepayment against the borrower or the Small Business Administration, except that the Administrator may impose a reasonable fee to cover the administrative expense with respect to processing such prepayment.

"(c) The Administrator of the Small Business Administration shall issue regulations to implement this section and to facilitate the prepayment of loans under this section within 60 days after the date of enactment of this section.".

○

504 Prepayment Penalty Calculation:

A prepayment penalty is paid only during the first half of the debenture term, and is calculated as a declining percentage of the debenture rate for the remaining principal amount at the time of prepayment.

EXAMPLE: Debenture = $300,000 Debenture Rate = 10%

Note: For Prepayment to occur at the end of the year

For a 10-year debenture term:

Year 1 = 100% of the deb. rate = 10.0% of $294,000 = $29,400
Year 2 = 80% of the deb. rate = 8.0% of $280,500 = $22,440
Year 3 = 60% of the deb. rate = 6.0% of $263,800 = $15,828
Year 4 = 40% of the deb. rate = 4.0% of $243,400 = $9,736
Year 5 = 20% of the deb. rate = 2.0% of $218,600 = $4,372
No penalty from Years 6 through 10

For a 20-year debenture term:

Year 1 = 100% of the deb. rate = 10.0% of $294,000 = $29,400
Year 2 = 90% of the deb. rate = 9.0% of $287,500 = $25,875
Year 3 = 80% of the deb. rate = 8.0% of $280,500 = $22,440
Year 4 = 70% of the deb. rate = 7.0% of $272,500 = $19,075
Year 5 = 60% of the deb. rate = 6.0% of $263,800 = $15,828
Year 6 = 50% of the deb. rate = 5.0% of $254,100 = $12,705
Year 7 = 40% of the deb. rate = 4.0% of $243,400 = $9,736
Year 8 = 30% of the deb. rate = 3.0% of $231,600 = $6,948
Year 9 = 20% of the deb. rate = 2.0% of $218,600 = $4,372
Year 10 = 10% of the deb. rate = 1.0% of $204,200 = $2,042
No penalty from Years 11 through 20

Acknowledgement

I (we) certify that I (we) have read this notice, and that I (we) have been given a copy of it.

Business Name: _____

By: _____ Date: _____
(Name & Title)

The CHAIRMAN. Mr. Compton.

STATEMENT OF DON T. COMPTON, PRESIDENT, WHITEWATER INDUSTRIES, HARRISON, OH

Mr. COMPTON. Thank you. Again I would like to express my thanks to the Committee and the Senator, and particularly Senator Metzenbaum, who I met with back in January, explained the situation, and he said he thought it was unfair and that he would try to do something about it.

The invitation to come to Washington was not to give you details about how to do this, but rather to tell you one simple story about how this loan affects Whitewater Industries, which is our company in Cincinnati.

We moved into a new factory in 1984, 20,000 square feet. We employed 14 people. We did about $1 million in business. Today we have 32 people, and we do about $3 million in business.

And it is successful because the 503 program existed. I was able to tap into it. And it allowed that to happen. I decided to put an addition onto the building, and I went to our primary bank, and I asked them about it and they said, fine, we will finance the whole package. You are solid now. You are doing well, and we will finance the entire package.

But, if we do that, we lose our first mortgage position, the SBA 503 now takes first and we become second. That is not good for us. So what we will do, you pay off the 503 program, and we will loan you the money for that purpose, and we will go ahead with the financing of your new building.

And that is when I learned about the exorbitant fee. In our case I owed $194,011, and the penalty was $82,830. That is 42.6 percent. And that is when I learned that the rose has thorns.The 503 program helped us out quite a bit at the beginning, but now it actually stopped me from making the next move, increasing our business, and creating new jobs.

So I said no, we are not going to do it. We can not do it. Our bank is a small bank, and they just would not take a second position.

Also I would like to address the person from the Treasury Department who was here and said that our loans are structured because you got this great deal. My rate with the 503 program is 13 percent for 40 percent of the loan.

My local bank, Northside Bank in Cincinnati, OH, loaned me 50 percent at 12.5 percent. I got a better situation there. The prepayment situation, if I paid off the Northside loan, I asked them, they said there would be no prepayment. Go ahead and pay it off if you have the money.

So the situation is that we needed the 503 program because of the amount of equity I could put in the original business. And that by financing 40 and 50 percent, and I put in 10 percent, it made the whole deal possible.

From my standpoint, we did not get an interest break. I paid 0.5 percent roughly more for that program. And now when I want to continue to expand, I find this hellatious penalty involved, and I just do not think it is fair.

The CHAIRMAN. Were you not aware of that at the time you signed the loan?

Mr. COMPTON. Yes, I was told at the signing that a prepayment formula existed that could result in a penalty. At that time, the 503 loan was the only way our new factory would be built. I was concerned abut making the monthly payments, not prepaying the loan with some unknown penalty. At that time of the signing no one envisioned a 43 percent penalty. No one realized how severe the penalty would really be. Now that the penalty is known, it is time to correct an unjust situation. I was aware of it, and actually I would not have even changed the rules. It is kind of like I shook hands on it and I forgot about it. I was going to pay my loan in full. The only reason I learned of the penalty was because my bank said, why not pay it off?

Now, since I found out about it, and I looked at it, if I did refinance, although that was not my original intention for looking at it, if I did refinance I would save $100,000 and pay the loan off 5 years earlier, the refinancing portion, 5 years earlier.

To me, that almost pays for my new addition. I could buy an NC-controlled punch press. Or I could hire a salesman or an engineer, and pay their salary for 2 years, if I had use of those funds.

So, the original intent was, I wanted to build a building, and this blocked me from doing it because of the bank's conditions. Now I say, hey, that is a tremendous investment that I can turn around and make it more productive. So now I want to go ahead and refinance. We are going to go ahead with the building.

Since that series of events, our local development corporation, David Main, who happens to be here, came and he said, look Don, if the refinancing is your real problem and the bank is reluctant to end up with a second, we will subordinate our position so that your bank will have a first, and we will still be in second position.

So that hurdle has been jumped because the CDC was cooperative with us and said we can do it. But regardless of that, I think my story is——

The CHAIRMAN. Well that is a pretty big concession. Is it not?

Mr. COMPTON. The CDC?

The CHAIRMAN. Yes.

Mr. COMPTON. I thought that was great. I agree with you. I thought that that would allow us to go ahead with the program. The answer to your question is yes! Our CDC made a big concession. Our Hamilton County Development Corporation's offer to subordinate their position to a private lender highlights a basic difference in thinking between the Treasury Department and the CDC.

The CDC wants to help small businesses grow. They want to see new factories built and to encourage the creation of new jobs. So they found a way to help.

The Treasury Department, however, refuses to consider a compromise. Instead, like Shylock, they demand their pound of flesh.

I believe that there are many small businesses out there who are sophisticated financial people, and I am not, that see this huge penalty and say, I just can not do that so I am not going to expand, I am not going to add the 5 jobs or 10 jobs that I thought I could do.

So I think that if there was some mechanism by which you could minimize that penalty. Now, whether you eliminate it, minimize it,

however you do it, if there is some mechanism that there is no longer a 40 or 50 percent penalty I would say that many small businesses would go ahead and expand, using that money that they saved from paying off that program, and do things a lot better for the whole Country.

I appreciate your time to consider this. I think it is very important for the really small business to have an opportunity to continue to grow, and I think Senator Metzenbaum's Bill, with amendments you consider necessary, I think that will allow it to happen. I believe it is clear that the 503 program's severe prepayment penalties are unreasonable and have stopped the growth of many small businesses.

S. 437, amended to protect the financial health of the local CDC, will correct this serious problem. Thank you.

The CHAIRMAN. Gentlemen, thank you both very much for a very persuasive and articulate testimony. I appreciate that.

You both made your cases extremely well, and we appreciate the time and effort you put into your statements and coming here to be with us today. Thank you.

Our last witness is Mr. David Main, director of Hamilton County Development Co. in Cincinnati. Mr. Main. Mr. Main, if it would be possible for you to summarize it would be very helpful to the Committee.

STATEMENT OF DAVID K. MAIN, EXECUTIVE DIRECTOR, HAMILTON COUNTY DEVELOPMENT CO., CINCINNATI, OH, AND PRESIDENT, NATIONAL ASSOCIATION OF DEVELOPMENT COMPANIES

Mr. MAIN. I will grant your request. I am actually wearing two hats this morning, Mr. Chairman. As executive director of Hamilton County Development Co., I am also president of the National Association of Development Companies, NADCO.

To my right is Roland Cook, who is affiliated with the Development Company Funding Corp., which is the 504 affiliate of NADCO.

Briefly I would like to just cover three key areas. One is the history and background of the 503 program. It was created by Congress is 1980 in order to solve a problem that many small businesses were facing, and that was the ability to obtain affordable financing.

I know that sounds somewhat ironic, now, after listening to this morning's testimony, but where the problems were was in the long term nature and the volatile interest rates of the late 1970s and 1980s.

What happened was the 503 program provided long term, fixed interest rate financing with a low down payment.

The CHAIRMAN. Mr. Main, let me interrupt just a moment. Do you have any idea how many of these loans, say, predate 1983?

Mr. MAIN. My guess would be somewhere around $300 million worth.

The CHAIRMAN. Out of a total of over $1 billion?

Mr. MAIN. About $1 billion. Yes.

The CHAIRMAN. So most of these loans have been made since 1983?

Mr. MAIN. I would say the majority of the loans have been made since 1983. That is correct.

The CHAIRMAN. What is the current rate for a loan under 503?

Mr. MAIN. The current rate for a loan under 503 is probably about 9 percent today.

The CHAIRMAN. What was it, say, 3 years ago?

Mr. MAIN. In 1984, in July, pardon me, in June it was 14.296 percent.

The CHAIRMAN. July of——

Mr. MAIN. In July 1984, 3 years ago. Almost 14.3 percent. That is the rate to the borrower.

The CHAIRMAN. Go ahead.

Mr. MAIN. The long term nature enabled them to lower their monthly debt service. The high leverage allowed them to come up with a 10 percent down payment, as opposed to conventional 20 to 30 percent down payment.

What we discovered, though, during the mid-1980s is that the small business concerns are not static entities, but they are dynamic entities. They grow, the contract, they expand. What we found is that many of these companies not only desire to pay off their loans, but they have to.

They need to build another building. They need to add an addition, or in a few cases they have gone out of business. We found that when we are tied to that, it has been somewhat of a straightjacket, as far as the 503 program is concerned.

We have another situation with a borrower in Hamilton County that took out a $39,000 loan, the current balance is $37,000. This gentleman needed to expand, he needed a $90,000 addition.

The prepayment premium on the $37,000 balance is $17,000. That is 46 percent of the loan balance. We are looking to perhaps proceed with some cooperation with the local SBA office and our board.

We have in some cases, Mr. Compton mentioned, been able to subordinate, or provide some type of other relief. But this only applies in cases where perhaps the property has appreciated, or the business is in reasonably good shape.

The other two points I would like to make, the second point regards the prepayment premium dilemma. And I think it was well addressed earlier this morning, but I think the fact remains that the Treasury is considering the premium based upon two points.

One is the high interest rate. Second of all is the government guarantee. Frankly, when the small business borrower comes in and prepays his loan, the guarantee is not being extended.

As we have learned previously, when the administration was looking to sell off these loans for an asset sale, they were looking at a substantial discount below par.

So it would seem that they are treating the investment bankers better than they are treating their own borrowers, for whom this program was intended to benefit. And it has benefited the small business borrowers, overall.

Ninety-seven percent of the borrowers, you asked the default rate, 97 percent of the borrowers that have 503 loans are current and are making payments. And I think it speaks well for the program.

The third point I would like to make is regarding to what do we do, maybe perhaps, beyond the intent of this Bill? I think we need to look at making the 504 financing available to the small business concerns.

This bill right now does not go far enough. The companies that are healthy, that are extremely healthy, they either have cash or ability to get conventional financing, will be helped because they can refinance these.

But we have companies that perhaps need to get out from under the high interest rates, more so, or need to somehow work around their financial dilemma. They are not going to be helped because they will not get conventional financing, or they do not have the cash to pay off the loan.

By converting these to 504 loans, they would maintain the fixed interest rate. They would maintain also the CDC servicing fees that are coming in. The CDCs are still providing a service. And we would be able to keep the borrowers intact.

So I think that one solution to this would be to extend 504 financing at 504 rates and prepayment premiums to 503 borrowers who wish to convert their 503 loans. I do not think it is our intention that CDCs, and as a representative of industry, want to get paid for something we are not doing.

With the 504 program continuing, we would be getting a service, we would be earning a fee for a service we are performing. We are required to service these loans.

SBA requires us to collect quarterly financial statements, review insurance, make sure the real estate property taxes are paid, and make periodic site visits to contact the borrowers. So we are providing a service for the fees that we are earning.

That is the summation of my testimony. We have submitted written testimony for the record.

[The prepared statement of Mr. Main follows:]

NADCO
National Association of Development Companies

STATEMENT
on
S. 437
concerning
PREPAYMENT OF LOANS MADE TO STATE AND
LOCAL DEVELOPMENT COMPANIES
before the
COMMITTEE ON SMALL BUSINESS
of the
UNITED STATES SENATE
by
David K. Main
June 18, 1987

Good morning. I am David Main, executive director of the Hamilton County Development Company in Cincinnati, Ohio, and president of the National Association of Development Companies, representing certified development companies that lend money to qualified small businesses under the SBA 503/504 loan program. With me today is Roland Cook of the Development Company Funding Corporation, a NADCO affiliate that acts as selling agent in the sale of 504 debentures to private investors.

Mr. Chairman, I want to thank you for the opportunity to appear before this Committee to discuss the stifling effects on small-business borrowers across the country of the prepayment premium assessed on SBA 503 loans by the Federal Financing Bank, which holds the debentures that fund those loans. I also want to thank Senator Metzenbaum for his efforts in bringing this issue to the attention of the Congress.

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You have heard this morning expert testimony from government officials on subjects ranging from how Treasury financings are booked to the complex theories supporting the prepayment terms FFB imposes on 503 debentures. I don't believe one can fail to be impressed by the theories that have been presented, and I will not try to refute them.

I would, however, like to put the theoretical aside for the moment and tell you about the very real impact of current practices on 503 borrowers around the country. About the jobs that are not being created or were lost. About the expansion and growth that did not happen. And in some extreme cases, about the difference between bankruptcy and survival.

The SBA 503 program was created by Congress in 1980 to help small businesses expand and create jobs by providing loans to acquire real estate, build new facilities and purchase equipment. Historically, small-business expansion has been stymied by the lack of availablity of affordable financing. The SBA 503 program helped alleviate this constraint by offering long-term loans, which require lower monthly debt-service payments, to finance fixed assets. These small-business loans carried fixed-interest rates with predictable future debt-service payments (in response to the volatile, high-interest rates of the late 1970's and early 1980's) and afforded the borrower a lower down payment than conventional financing (ten percent vs. 20 or 30 percent). The reduced down payment allowed the small business to conserve cash for badly needed working capital.

The SBA 503 program worked. Since its inception in early 1981, almost $900 million in small-business loans have been approved and closed. More than 100,000 jobs have been created. The overwhelming majority of these small businesses (97 percent), who were able to expand and create jobs in their communities because of this financing, are repaying their debt according to schedule. However, along the way we discovered that small businesses are

dynamic rather than static entities. Their opportunities for growth do not always appear in an orderly or predictable fashion. Yet, small businesses have been the primary economic-growth and job generators of the 1980's. As a result, many 503 borrowers now have the ability and desire to expand beyond their original 503-financed project.

For those small businesses who closed 503 loans when interest rates were high, the prepayment premium associated with those loans has become a straight jacket, stifling such expansion. In Hamilton County, Ohio, one small company with a 503 loan carrying an outstanding loan balance of $37,000 needed to expand its facility with a $90,000 addition. In order to prepay its 503 loan, which carries an interest rate of 14.296 percent, the company would have had to pay a premium of nearly $17,000 -- approximately 46 percent of the outstanding loan balance. This $17,000 premium would have eaten into business capital that was already targeted for the expansion, for new equipment and additional employees. Because of the premium, this expansion and similar expansions by countless 503 borrowers around the country have been either delayed or abandoned.

The effects of the prepayment premium such as I have described seem incongruous with the original intent and purpose behind the SBA 503 program -- to assist and foster small-business expansion with affordable financing.

This is just one example of the impact the FFB's prepayment premium can have on a small-business borrower. Additional examples of small businesses caught in the high-interest rates and expensive 503 prepayment premiums are included in this statement as Attachment A.

As a professional in the field of economic development and small-business finance, it is extremely troubling to me to see loans that I made to small businesses in my community just a few years ago today stifling those very same businesses with

fixed-interest rates as much as four points higher than what we now are able to offer our borrowers and prepayment premiums of 30, 40, and in some cases almost 50 percent of the outstanding principal balance of their loans.

I am told that the FFB's prepayment formula, which is yielding these very high premiums, is based on the price at which the FFB estimates a Treasury security with the same remaining maturity and same interest rate would sell in the market -- in other words, its current market value. In the case of certain small-business loans made when interest rates on 20- and 25-year FFB loans were as high as 12, 13, in some cases even 15 percent, the FFB's formula is creating premiums far in excess of penalties contained in call provisions of comparable bank loans or corporate-market securities. As I mentioned, these premiums are based on what price comparable Treasury securities yield in the market. In fact, no actual sale of 503 debentures has ever occured. The FFB is holding all the 503 debentures it has purchased since the program's inception.

Therefore, if the FFB were directed by Congress to modify its prepayment penalty, or even allow prepayment at par, there would be no actual dollar loss to the federal government. True, the government would be giving up an opportunity for future profit should it at some point decide to sell the debentures to investors. However, the sale of a 503 security to the original borrower is significantly different than a sale to a private investor.

The huge premiums 503 loans would command in the private market are the result of two factors from the investor's point of view. One, of course, is the high-interest rate the securities carry. The other, however, has to do with the government's guarantee of timely payment of principal and interest, and here is where the government's argument breaks down. They are valuing the debenture at its worth as a guaranteed obligation of the federal government.

In fact, in a prepayment situation, the government guarantee is not extended to the purchaser (who is also the borrower). Therefore, a more accurate measure of the debenture's value in a prepayment situation would be based on what the debenture would sell for were it offered to investors without the federal guarantee.

In repeated testimony before both Houses of Congress, the Administration has estimated the value of these assets should they be sold without the guarantee (a "non-recourse" sale) to be less than par. In fact, the Administration's FY 1988 budget proposal takes the very same obligations that the FFB is requiring borrowers to prepay at huge premiums and proposes to sell them without recourse at a discount to Wall Street investment bankers. Why? Because without the guarantee they can no longer demand the kind of premium the market will pay for a federally guaranteed asset.

Therefore, one could argue, by enforcing payment of these huge premiums on purchasers to whom the federal guarantee is not being extended, the FFB is securing a windfall for the Treasury at the considerable expense of those purchasers (the individual small-business borrowers). This, in my opinion, is at best a curious way for the federal government to treat the small-business borrowers it was supposedly intending to assist.

Senator Metzenbaum, responding to the concerns brought to him initially by Ohio borrowers -- some of whom received their 503 loans through Hamilton County Development Company -- introduced the legislation we are discussing today. Essentially, the bill would preclude the FFB from imposing a premium on borrowers who wish to prepay their 503 loans. While we share some of the technical concerns raised by SBA in its testimony, we wholeheartedly agree with the intent of the bill: to remove the stranglehold the FFB's high-interest rates and prepayment formula have placed on certain 503 borrowers. However, we believe that this bill does not go far enough. Implementation of S. 437 in its current form would continue to disenfranchise those borrowers most in need of relief,

and would jeopardize the viability of the development-company system upon which small-business borrowers are dependent for providing 504 financing in the years to come.

For existing 503 borrowers, the ability to prepay at par is only a solution for those small businesses who are capable of obtaining conventional financing to replace their high-interest 503 loans. The whole point of the development company loan program is to allow small businesses who cannot get conventional financing to expand, create jobs, and spur economic development in their communities. As the bill is written, only those businesses who are now able to obtain conventional financing to pay off their 503 loans will benefit.

In addition, losing even a relatively small amount of servicing income through prepayment could tip the balance for many CDCs that are already struggling to become self-sufficient. Faced with an unexpected loss of even 10 to 15 percent of their servicing income, many CDCs (the vast majority of whom are non-profit) would find it impossible to continue to package 504 loans. CDCs are a crucial conduit in providing 504 loans to qualified small businesses. If a CDC shuts down, it is the local small businesses who will suffer the loss of opportunity to use this lending program.

Therefore, we would recommend that Congress go one step further to better serve the needs of those it intended to assist in the first place, and to assure an ongoing delivery system for future 504 borrowers.

By allowing 503 small-business borrowers the option to refinance their loans through the 504 private-sale process at current private-market rates and commercial prepayment terms, Congress would indeed assist those borrowers in continuing to contribute to their local communitites.

A 503 borrower with a high-interest rate loan would benefit in two ways from converting to a private-market 504 loan. The first is rate. The interest rate for 504 borrowers receiving funds this month is 9.75 percent, fixed for 20 years. Clearly, 503 borrowers with interest rates higher than, say, 12 percent (30 percent of all 503 borrowers) would benefit from the rates available in today's market. The second is relief from the oppressive prepayment premiums. Should the small-business borrower's business situation make prepayment under reasonable terms an option he wishes to retain for the future, the 504's commercial-type prepayment premium is more attuned to private business and less subject to the vagaries of changing interest rates than the formula used by FFB.

The prepayment premium arrangement in the 504 private-market program is designed to balance the needs of investor and borrower. Initially, the premium is equal to one year's interest. It declines to zero in yearly increments through the first half of the term of the loan. Thereafter, the borrower may prepay at par. We have been told by investment bankers that any deviation from the "non-call" structure of Treasury securities has a price in the market. They estimated at the time the 504 debenture was being developed that this particular prepayment term would likely add 15 to 20 basis points to the interest rate borrowers pay on their 504 loans. A majority of CDCs believed that their borrowers would gladly pay the slightly higher interest rate for the ability to prepay at a reasonable premium that was known in advance. A prepayment schedule for a 20-year, $500,000 loan sold in June is included in this statement as Attachment B.

By allowing small-business borrowers to prepay their high-interest 503 loans at par and replace them with 504 loans sold to private investors, Congress would be providing those borrowers with immediate interest-rate relief, as well as permanent protection from usurious premiums for prepayment. An added benefit to the government would be SBA's ability to prepay at par in the

event of a default. Currently, SBA is paying the same premium borrowers incur when paying off a debenture pursuant to its guarantee.

We estimate that 30 to 40 percent of the outstanding 503 portfolio ($250 to $350 million) would be repaid to the FFB and converted to 504 loans through the private-market sale of development-company debentures if borrowers were given the option. In looking at the overall plusses and minuses to the government of such a conversion we would offer these points:

* If the refinancing were authorized, the government would receive between $250 and $350 million in prepayment of 503 loans, which we understand would be scored as a negative outlay which reduces SBA outlays and the federal deficit. The 504 loans made to replace those 503 obligations would not constitute a direct federal outlay since the funds would be provided by investors through a public offering.

* If Congress decides that a new appropriation is needed to accommodate those small-business borrowers wishing to refinance, SBA's appropriation for the 504 program for the year in which the refinancing occurs will have to be increased. However, the need for new appropriations might be avoided if the refinancing were to occur before the end of this fiscal year. Authority that has been appropriated for other SBA loan-guarantee programs, but will not be used before the end of the year due to lack of demand in those programs, may be sufficient to allow for a reallocation of appropriated authority.

* Finally, the authorizing legislation needed to implement a refinancing such as we have described would have to specifically provide that 503 borrowers who prepay according to the terms of that legislation would be eligible for 504 financing.

We would envision that 504 loans made to borrowers who had opted to prepay their 503 loans would be packaged as any normal 10- or 20-year 504 loan and would be sold in the market as part of our normal monthly pools. Former 503 borrowers participating in those financings would be assessed normal fees associated with the funding.

We would be happy to provide any additional information this Committee would request concerning the proposal we have presented this morning.

Thank you, Mr. Chairman, for the opportunity to appear before you. I would be happy to answer any questions you or other members of the Committee may have.

ATTACHMENT 5

Company Name: Central States Concrete Products Inc.

Address: P.O. Box 3508
Napa, CA 94558

Original Loan Amount: $212,000

Interest Rate: N/A

Current Balance: $207,550

Estimated
Prepayment Penalty: $ 91,007

Comments:

Company Name: EJR Plastics Inc.

Address: 4901 Pacific Highway
San Diego, CA 92110

Original Loan Amount: $250,000

Interest Rate: N/A

Current Balance: $245,012

Estimated
Prepayment Penalty: $ 57,261

Comments:

Caught between the high interest rates of the 503 program and a recession among high technoloby firms in the Silicon Valley, EJR Plastics was forced to sell the branch operation SBA had helped to finance and pay a 23% prepayment premium in order to preserve operations at its main location in San Diego.

Company Name: Glenn Design Company

Address: 819 Bridgeway
Sausalito, CA 94965

Original Loan Amount: $500,000

Interest Rate: 14.67%

Current Balance: $489,621

Estimated
Prepayment Penalty: $116,000

Comments:

Company Name: California Sample Furniture Company

Address: 935 Texas Street
Fairfield, CA 94533

Original Loan Amount: $330,000

Interest Rate: 14.67%

Current Balance: $323,402

Estimated
Prepayment Penalty: $ 80,000

Comments:

Company Name: Zucco Associates

Address: 880 Second Street
Santa Rosa, CA 95404

Original Loan Amount: $116,000

Interest Rate: N/A

Current Balance: $ 96,402

Estimated
Prepayment Penalty: $ 23,010

Comments:

Company Name: Glazier's Foodtown

Address: 265 South 100 East
Kanab, UT 84741

Original Loan Amount: $168,000

Interest Rate: 12.873%

Current Balance: $152,145

Estimated
Prepayment Penalty: $ 48,600

Comments:

With the narrow profit margins associated with the retail food industry, debt service is important to this company's bottom line. The ability to refinance at current 504 rates would result in nearly a $7,500 annual debt service savings. It is imporant to note that this business would find it nearly impossible to refinance through any other program other than 504 due to the sluggish economy in rural Utah.

Company Name: Daines Enterprises

Address: 184 East 5300 South
Murray, UT 84107

Original Loan Amount: $ 80,000

Interest Rate: 14.859%

Current Balance: $ 78,499

Estimated
Prepayment Penalty: $ 30,600

Comments:

Company Name: Westside Shortstop

Address: Mason City, Iowa

Original Loan Amount: $ 57,000

Interest Rate: 12.24

Current Balance: $ 54,474

Estimated
Prepayment Penalty: $ 14,336

Comments:

Company Name: Westpointe Car Wash

Address: Clive, Iowa

Original Loan Amount: $500,000

Interest Rate: 12.856

Current Balance: $476,927

Estimated Prepayment Penalty: $143,078

Comments:

Company Name: Voorhees Kersten Partnership

Address: West Des Moins, Iowa

Original Loan Amount: $150,000

Interest Rate: 13.995

Current Balance: $149,250

Estimated Prepayment Penalty: $ 22,110

Comments:

Company Name: Dultmeier Sales, Inc.

Address: Davenport, Iowa

Original Loan Amount: $225,000

Interest Rate: 15.246%

Current Balance: $190,617

Estimated
Prepayment Penalty: $ 89,590

Comments:

Company Name: Controller Experimental Pathology Laboratories

Address: P.O. Box 474
Herndon, VA 22070

Original Loan Amount: N/A

Interest Rate: N/A

Current Balance: $135,600

Estimated
Prepayment Penalty: $ 21,000

Comments:

Company Name: Commonwealth Copy Products

Address: 10890 Lee Highway
Fairfax, VA 22030

Original Loan Amount: N/A

Interest Rate: N/A

Current Balance: $278,000

Estimated
Prepayment Penalty: $ 36,000

Comments:

Company Name: Capital Cycle Corporation

Address: 1508 Moran Road
Sterling, VA 22170

Original Loan Amount: N/A

Interest Rate: N/A

Current Balance: $260,000

Estimated
Prepayment Penalty: $ 47,000

Comments:

Company Name: Pacific Electric Supply

Address: 1906 Republic Avenue
San Leandro, CA 94577

Original Loan Amount: $420,000

Interest Rate: 12.883%

Current Balance: $414,908

Estimated
Prepayment Penalty: $206,000

Comments:

Company Name: Sokel Park, Inc.

Address: 50 Julian Avenue
San Francisco, CA 94103

Original Loan Amount: $294,000

Interest Rate: 12.268%

Current Balance: $290,017

Estimated
Prepayment Penalty: $122,280

Comments:

Company Name: Spacesonics, Inc.

Address: 110 Constitution Drive
Menlo Park, CA 94025

Original Loan Amount: $443,000

Interest Rate: 12.637%

Current Balance: $434,789

Estimated
Prepayment Penalty: $215,724

Comments:

Company Name: World Tire Corporation

Address: 4435 South 13th Place
Tukwila, WA 98188

Original Loan Amount: $458,000

Interest Rate: 15.056%

Current Balance: $444,600

Estimated
Prepayment Penalty: $195,647

Comments:

Company Name: Roberge Sheet Metal

Address: 3411 First Avenue South
Seattle, WA 98134

Original Loan Amount: $462,000

Interest Rate: 13.917%

Current Balance: $448,600

Estimated
Prepayment Penalty: N/A

Comments:

Company Name: Green River Sportswear

Address: 4020 South 56th Street
Tacoma, WA 98409

Original Loan Amount: $420,000

Interest Rate: 11.216%

Current Balance: $404,900

Estimated
Prepayment Penalty: $115,259

Comments:

Company Name: Amber Light Motor Inn

Address: West Highway 76
Branson, MO 65616

Original Loan Amount: $280,000

Interest Rate: N/A

Current Balance: $264,321

Estimated
Prepayment Penalty: $ 57,000

Comments:

Company Name: Apple Mill Restaurant

Address: P.O. Box 1413
Branson, MO 65616

Original Loan Amount: $129,000

Interest Rate: N/A

Current Balance: $125,121

Estimated
Prepayment Penalty: $ 35,000

Comments:

Borrower has experienced cash flow problems, resulting in deferment of payments.

Company Name: Bowman's Country Restaurant & Motel

Address: West Highway 76
Branson, MO 65616

Original Loan Amount: $446,000

Interest Rate: N/A

Current Balance: $437,736

Estimated
Prepayment Penalty: $100,000

Comments:

Borrower has experienced cash flow problems, resulting in deferment of payments.

Company Name: Garcia's of Scottsdale

Address: 909 Business Loop
Columbia, MO 65201

Original Loan Amount: $500,000

Interest Rate: N/A

Current Balance: $465,974

Estimated
Prepayment Penalty: $100,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Houston House

Address: W. Highway 17 & N. Industrial
Houston, MO 65483

Original Loan Amount: $147,000

Interest Rate: N/A

Current Balance: $142,117

Estimated
Prepayment Penalty: $ 27,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Hudson House

Address: P.O. Box 438
Aurora, MO 65605

Original Loan Amount: $132,000

Interest Rate: N/A

Current Balance: $123,017

Estimated
Prepayment Penalty: $ 25,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Ozark Transportation, Inc.

Address: P.O. Box 4057
Poplar Bluff, MO 63901

Original Loan Amount: $140,000

Interest Rate: N/A

Current Balance: $137,128

Estimated
Prepayment Penalty: $ 40,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Wendy's of SWMO, Inc.

Address: 1722-H South Glenstone
Columbia, MO 65201

Original Loan Amount: $389,000

Interest Rate: N/A

Current Balance: $367,974

Estimated
Prepayment Penalty: $ 80,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Zoltek Properties, Inc.

Address: 3101 McKelvey
Bridgeton, MO 63044

Original Loan Amount: $500,000

Interest Rate: N/A

Current Balance: $486,118

Estimated
Prepayment Penalty: $120,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Dobsch & Wichern Equipment Co.

Address: Hwys. 32 & I-55
St. Genevieve, MO 63670

Original Loan Amount: $122,000

Interest Rate: N/A

Current Balance: $118,612

Estimated
Prepayment Penalty: $ 25,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Con P. Curran Printing Co.

Address: 500 Curran Drive
Fredricktown, MO 63645

Original Loan Amount: $500,000

Interest Rate: N/A

Current Balance: $486,118

Estimated
Prepayment Penalty: $120,000

Comments:

Borrower has experienced cash flow problems.

Company Name: Edwards Gas-n-Shop

Address: 1509 N. Scott
Belton, MO 64012

Original Loan Amount: $ 67,000

Interest Rate: N/A

Current Balance: $ 64,598

Estimated
Prepayment Penalty: $ 19,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Special D Meats

Address: Route 3 Box 253
Macon, MO 63552

Original Loan Amount: $ 73,000

Interest Rate: N/A

Current Balance: $ 70,536

Estimated
Prepayment Penalty: $ 20,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Johnny's Butcher Shop

Address: Route 6
Jefferson City, MO 65101

Original Loan Amount: $ 47,000

Interest Rate: N/A

Current Balance: $ 43,297

Estimated
Prepayment Penalty: $ 9,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Oak Grove Truck Stop

Address: P.O. Box 6
Oak Grove, MO 64075

Original Loan Amount: $193,000

Interest Rate: N/A

Current Balance: $186,589

Estimated
Prepayment Penalty: $ 40,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Fordick Corporation

Address: 210 Oak Street
Mountain Grove, MO 65711

Original Loan Amount: $200,000

Interest Rate: N/A

Current Balance: $172,640

Estimated
Prepayment Penalty: $ 70,000

Comments:

Borrower would refinance to lower the interest rate.

Company Name: Bart Starr Imports

Address: N/A

Original Loan Amount: N/A

Interest Rate: 12.840%

Current Balance: $491,668

Estimated
Prepayment Penalty: $ 88,430

Comments:

Company Name: Sanwrons of Alabama

Address: N/A

Original Loan Amount: N/A

Interest Rate: 13.704%

Current Balance: $ 48,608

Estimated
Prepayment Penalty: $ 20,634

Comments:

Company Name: McArthur Medical Associates

Address: N/A

Original Loan Amount: N/A

Interest Rate: 13.704%

Current Balance: $326,650

Estimated
Prepayment Penalty: $131,670

Comments:

Company Name: Valley Cleaners

Address: N/A

Original Loan Amount: N/A

Interest Rate: 13.704%

Current Balance: $ 48,984

Estimated
Prepayment Penalty: $ 17,884

Comments:

Company Name: Charles Bordenca

Address: N/A

Original Loan Amount: N/A

Interest Rate: 11.300%

Current Balance: $ 54,864

Estimated
Prepayment Penalty: $ 12,110

Comments:

Company Name: FoxTrap

Address: N/A

Original Loan Amount: N/A

Interest Rate: 13.158%

Current Balance: $ 60,035

Estimated
Prepayment Penalty: $ 20,162

Comments:

Company Name: Thompson's Bumper to Bumper

Address: N/A

Original Loan Amount: N/A

Interest Rate: 12.827%

Current Balance: $ 41,985

Estimated
Prepayment Penalty: $ 14,896

Comments:

Company Name: B & B Drugs, Inc.

Address: N/A

Original Loan Amount: N/A

Interest Rate: 12.827%

Current Balance: $ 63,932

Estimated
Prepayment Penalty: $ 21,963

Comments:

Company Name: Crestwood Pharmacy

Address: N/A

Original Loan Amount: N/A

Interest Rate: 12.806%

Current Balance: $109,619

Estimated
Prepayment Penalty: $ 28,241

Comments:

Company Name: MetroMart, Inc.

Address: N/A

Original Loan Amount: N/A

Interest Rate: 14.791%

Current Balance: $ 65,029

Estimated
Prepayment Penalty: $ 32,887

Comments:

Company Name: ShowBiz Pizza

Address: N/A

Original Loan Amount: N/A

Interest Rate: 12.338%

Current Balance: $184,982

Estimated
Prepayment Penalty: $ 62,107

Comments:

Company Name: Thrifty Rent a Car

Address: N/A

Original Loan Amount: N/A

Interest Rate: 9.075%

Current Balance: $165,000

Estimated
Prepayment Penalty: $ 13,906

Comments:

Company Name: Railroad Car Service Corporation

Address: N/A

Original Loan Amount: $157,000

Interest Rate: 13.676%

Current Balance: N/A

Estimated
Prepayment Penalty: $ 64,323

Comments:

Company Name: Concrete and Masonry Products of Harlan, Inc.

Address: N/A

Original Loan Amount: $293,000

Interest Rate: 13.776%

Current Balance: $271, 265

Estimated
Prepayment Penalty: N/A

Comments:

Company Name: Carrier Vibrating Equipment, Inc.

Address: N/A

Original Loan Amount: $500,000

Interest Rate: 12.865%

Current Balance: $472,069

Estimated
Prepayment Penalty: N/A

Comments:

ATTACHMENT B

U.S. GOVERNMENT GUARANTEED 9.75% DEVELOPMENT COMPANY
PARTICIPATION CERTIFICATE - SERIES 1987-20F
PREPAYMENT SCHEDULE

Name of C D C:	STANISLAUS COUNTY ECONOMIC DEVELOPMENT CORPORATION		
Name of S B C:			
Debenture Number:	1987-20F		
Interest Rate:	9.75%	Debenture P/A:	500,000.00
Semi-Annual Payments:	28,523.68	Term (in years):	20
Payment Dates:	December 1 and June 1	Final Maturity:	June 1, 2007

Payment Dates	Remaining Principal Amount	Prepayment Rate (in %)	Prepayment Amount
December 1, 1987	493,684.66	109.750%	541,818.91
June 1, 1988	489,228.11	109.750%	536,927.85
December 1, 1988	484,554.31	108.775%	527,073.95
June 1, 1989	479,652.65	108.775%	521,742.17
December 1, 1989	474,512.05	107.800%	511,523.98
June 1, 1990	469,120.83	107.800%	505,712.26
December 1, 1990	463,466.80	106.825%	495,098.41
June 1, 1991	457,537.13	106.825%	488,764.04
December 1, 1991	451,318.39	105.850%	477,720.52
June 1, 1992	444,796.49	105.850%	470,817.08
December 1, 1992	437,956.64	104.875%	459,307.03
June 1, 1993	430,783.35	104.875%	451,784.04
December 1, 1993	423,260.36	103.900%	439,767.52
June 1, 1994	415,370.63	103.900%	431,570.09
December 1, 1994	407,096.27	102.925%	419,003.84
June 1, 1995	398,418.54	102.925%	410,072.29
December 1, 1995	389,317.77	101.950%	396,909.47
June 1, 1996	379,773.34	101.950%	387,178.92
December 1, 1996	369,763.61	100.975%	373,368.81
June 1, 1997	359,265.92	100.975%	362,768.76

U.S. GOVERNMENT GUARANTEED 9.75% DEVELOPMENT COMPANY
PARTICIPATION CERTIFICATE - SERIES 1987-20F
PREPAYMENT SCHEDULE

Name of C D C:	STANISLAUS COUNTY ECONOMIC DEVELOPMENT CORPORATION		
Name of S B C:	FRANK PATTERN AND MANUFACTURING, INC.		
Debenture Number:	1987-20F/09-593-492		
Interest Rate:	9.75%	Debenture P/A:	500,000.00
Semi-Annual Payments:	28,523.68	Term (in years):	20
Payment Dates:	December 1 and June 1	Final Maturity:	June 1, 2007

Payment Dates	Remaining Principal Amount	Prepayment Rate (in %)	Prepayment Amount
December 1, 1997	348,256.45	100.000%	348,256.45
June 1, 1998	336,710.28	100.000%	336,710.28
December 1, 1998	324,601.23	100.000%	324,601.23
June 1, 1999	311,901.87	100.000%	311,901.87
December 1, 1999	298,583.41	100.000%	298,583.41
June 1, 2000	284,615.67	100.000%	284,615.67
December 1, 2000	269,967.01	100.000%	269,967.01
June 1, 2001	254,604.23	100.000%	254,604.23
December 1, 2001	238,492.51	100.000%	238,492.51
June 1, 2002	221,595.35	100.000%	221,595.35
December 1, 2002	203,874.44	100.000%	203,874.44
June 1, 2003	185,289.65	100.000%	185,289.65
December 1, 2003	165,798.84	100.000%	165,798.84
June 1, 2004	145,357.86	100.000%	145,357.86
December 1, 2004	123,920.38	100.000%	123,920.38
June 1, 2005	101,437.83	100.000%	101,437.83
December 1, 2005	77,859.25	100.000%	77,859.25
June 1, 2006	53,131.21	100.000%	53,131.21
December 1, 2006	27,197.68	100.000%	27,197.68
June 1, 2007	0.00	100.000%	0.00

The CHAIRMAN. We appreciate your testimony very much, Mr. Main. I think your proposal to convert this over to 504 financing is probably the correct one.

This bill obviously is going to be amended to some extent in this Committee. Right now, whatever we may do about this I think we have to make sure that the CDCs are not devastated with whatever we do.

Converting this over to 504 financing seems like a fairly legitimate approach to me.

Mr. MAIN. I think it could also result in what they call a negative outlay to the Treasury, because in essence by taking 504 off budget there is a savings. I understand there has been a bill marked up to convert the remaining——

The CHAIRMAN. It would have a favorable impact on the budget. That is true. You know, if we had sold these portfolios on Wall Street, obviously Wall Street reaps a windfall out of this.

And I have opposed that and I am going to continue to oppose it. We can collect those loans and save the taxpayers of this Country unbelievable amounts of money. The asset sale proposal was a cockamamie scheme from the very beginning.

And yet the administration wants to do that, but if you try to give small business a chance to pay something off, they get zip. As a matter of fact, they get penalized. So just from an equitable position, it seems to me that the administration finds themselves in a very complicated position.

If this were standing alone, then I would say that we need to give some relief to these people but not perhaps as dramatic a relief as the Bill would provide. But we certainly can not vote to let REAs come in here and pay off $8 billion worth of loans at discounts, and not permit proposals like this to go through.

I would like to say to everyone here this morning that this hearing has been extremely informational to me. I have learned a great deal from the testimony this morning, and I appreciate your concern and I assure you that these issues will be addressed in the Bill when it is finally marked up in this Committee.

I thank all of you very much for coming this morning. This Committee will stand in recess until the next call of the Chairman.

[Whereupon, at 11:15 a.m. the hearing was adjourned.]

APPENDIX

7-6-87

Miss Tracy Crowley, Hearing Clerk
Committee on Small Business
Room 428A
Russell Senate Office Bldg.
Washington, D.C. 20510-6350

Re: Bill S. 437

Dear Ms. Crowley

In 1984 I purchased a building in Hamden, Conn. with the aid of SBA financing under the 503 Loan Program.

Since that time mortgage rates have decreased approx. 50% from my initial rate and accordingly I will incur a penalty of approx. $70,000.00 upon the sale of my building which will be consumated on or around 8-1-87.

Unfortunately my business took a turn for the worse and I had no alternative but to sell my building as I was no longer able to meet the annual expenses.

Although my building appreciated in value since the date of purchase I still believe the penalty ($70,000.000) is excessive and to be candid unfair re. prepayment of a mortgage/loan.

My only other option was to lease the building which makes good sense, however under the 503 Program there is yet another regulation which states that (as the owner) I would still have to occupy approx 50% of the building which I could not substantiate when I took the current status of my business into consideration. In addition, it would be very expensive to sub-divide my building for a tenant.

I sincerely regret that business reasons prevented my from appearing at your 6-18-87 hearing but I hope that this letter will be useful to your committee.

Thank you very much for your time and consideration.

Sincerely,

Richard Frankel
Orange, Conn. 06477